Annual Investment Industry Seminar

November 8, 2023

www.kmco.com

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

GIPS Update

Tom Peters, CPA, CIPM,
Director, Investment
Industry Group

Ashley Jiang, CPA, CIPM,
Manager,
Audit & Accounting,
Investment
Industry Group

www.kmco.com

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Agenda

1. OCIO
2. GIPS Standards Update

Draft OCIO GS

- What is an OCIO? From the Draft GS:
- *An OCIO provides investment advice and investment management services on an outsourced basis for Total OCIO Portfolios of institutional investors, such as pension funds, endowments, and foundations. An OCIO acts as a fiduciary, and its responsibilities typically include spending policy / liabilities analysis, investment policy development, portfolio construction, and ongoing portfolio management. OCIO investment advice can take different forms but often includes learning about the asset owner's financial objectives, including any return objectives or liabilities, and helping to develop the strategic asset allocation and investment policy statement for the asset owner's Total OCIO Portfolio. An OCIO is then responsible for implementing the investments for the Total OCIO Portfolio.*

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

- What is an OCIO? More definitions:
- *An OCIO Strategy is defined as a strategy in which a firm provides investment advice and investment management services on an outsourced basis for Total OCIO Portfolios of institutional investors, such as pensions, endowments, and foundations.*
- *A Total OCIO Portfolio is defined as a pool of assets managed by a firm in an OCIO Strategy according to an institutional investor's investment mandate, which is typically composed of multiple asset classes. The Total OCIO Portfolio usually consists of underlying portfolios, each representing one of the strategies used to achieve the Total OCIO Portfolio's investment mandate*

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

- What is an OCIO? More definitions:
- *A Total OCIO Portfolio will have the following characteristics:*
  - *It is a portfolio of an institutional client for which the firm has provided investment advice as to the asset allocation of the total portfolio.*
  - *It is composed of multiple asset classes.*
  - *It is not a portion of a larger portfolio with a strategic asset allocation that considers other asset classes.*
- Some of these services may require client approval. This doesn't take a firm out of OCIO classification.
- Does not apply to FMPs – special UK Pension Schemes which have their own section of GIPS.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

Who uses OCIOs?

- Asset owners (such as pension plans, endowments, foundations, etc…)
- AUM isn’t large enough to justify / support having a dedicated investment team on staff

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

Why use an OCIO?

- Provides benefits of outsourcing expertise in asset allocation, investment management
- Often provided the ability to get into alternative asset classes at lower AUM levels through funds
- Administrative support (back office and other resources)

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

Isn't regular GIPS enough for OCIOs? Why is the draft guidance statement needed?

Well……no, regular GIPS isn't enough.

The OCIO marketplace has:

1. Asset owners (clients)
2. OCIOs
3. Consultants

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

Isn't regular GIPS enough for OCIOs? Why is the draft guidance statement needed?

- Consultants have been complaining about the lack of comparability, and
- OCIOs have been complaining about all of the ad hoc reporting they need to do when consultants put out an RFP.
- Other complaints included transparency (lack thereof), treatment of fees, the calcs themselves, and disclosures.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

Why guidance for OCIOs is needed:

The complaints were legitimate as firms were taking different approaches for presenting performance (even when following GIPS):

- Composites not comparable between firms (truly apples to oranges)
- Treatment of legacy assets
- How benchmarks were used
- How discretion was determined
- Treatment of fees (there are several layers) and which return calcs are presented

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

So the CFA Institute formed the GIPS Standards OCIO Working Group to address these issues.

The Working Group consists of people from:

- OCIOs
- Consultants
- Verifiers
- CFA Institute Staff

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

What does the Draft GS do?

OCIOs must create composites consistent with the structure laid out in the GS.

Two main buckets:

- *Liability – focused composites are managed with an objective to meet a liability stream for some or all of the client's assets. Examples include corporate pension fund and insurance portfolios.*
- *Total return objective composites are managed with total return objective and no liability matching, e.g., endowments and foundations. Examples include endowment, foundation, Taft-Hartley pension fund, operating reserve, and family office portfolios.*

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

Composite structure continued:

The two main composite buckets are further broken down by the portfolio's allocations to the following (% provided by category in draft GS):

Liability-focused

- Liability-hedging assets
- Growth assets

Total return

- Risk-mitigating assets
- Growth assets

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

Asset classes examples for liability-focused:

- Liability-hedging – government bonds, high quality corporates, derivatives of these
- Growth – everything else

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

Asset classes examples for Total return:

- Growth assets – used to seek returns and increase risk, such as equities, high-yield bonds, PE
- Risk-mitigating assets are everything else

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

More composite info:

- When utilizing the composite structure, Total OCIO Portfolios must be assigned to a Required OCIO Composite based on the portfolio's target asset allocation, not the actual asset allocation weights.
- Can have other composites in addition to what is required
- Legacy assets (such as PE from prior OCIO) – OCIO's need to establish a policy on how to handle and disclose policy.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

What else does the GS cover?

- Benchmarks
- Required returns (TWRR, gross, net, etc…)
- Disclosures

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Draft OCIO GS

Dates:

- Proposed effective date would be 12 months after the GS is issued. So firms would have a year to implement.
- Comment period ends 11/20/23.
- CFA Institute and OCIO Working Group will review comments and issue the final GS.
- Your opinion matters. If this applies to your firm, please submit a response to the CFA Institute to let us know your opinion. Details are on the GIPS website.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

GIPS Standards Update

GIPS Update

- Current State
- Highlights from the Revised Guidance Statement on Benchmarks for Firms
- Survey Report of Firms on GIPS Standards Error Correction Policies
- Help Desk Questions from the GIPS Standards Newsletter

Current State

- According to Pensions & Investments data
  - 24 of top 25 global firms claim compliance for all or a part of their assets
  - 90 of top 100 global firms claim compliance for all or a part of their assets
- Top five markets
  - US
  - UK
  - Canada
  - Switzerland
  - Japan

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Highlights From the Revised Guidance Statement on Benchmarks for Firms

- When the benchmark is a peer group, it is expected that the benchmark description would include whether the peer group benchmark is gross or net of fees
- A benchmark that is reduced by transaction costs should be clearly labeled as such
- Includes an example for calculating a leveraged benchmark
- When a custom leveraged benchmark is used, an unlevered benchmark should also be presented

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Highlights From the Revised Guidance Statement on Benchmarks for Firms

- For a multi-asset class strategy that uses a multi-asset class benchmark, in most cases the strategic-weight benchmark is the appropriate benchmark
- When an actual weight benchmark is used, benchmark description would include the fact that the benchmark reflects actual weights rather than strategic weights
  - Should disclose that the benchmark eliminates the impact of asset-allocation decisions
  - Should also include a strategic-weight benchmark

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Highlights From the Revised Guidance Statement on Benchmarks for Firms

- A lagged benchmark reflects returns that are not current
  - Example: the private equity component of a multi-asset class benchmark is reported on a quarter lag
- Lagged benchmark returns should match the timing of the returns for the respective asset class
- Should disclose that there is a difference in valuation dates for the lagged asset classes

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Highlights From the Revised Guidance Statement on Benchmarks for Firms

- If a multi-asset class benchmark has an asset class benchmark that is not available in a timely fashion, when calculating the multi-asset class benchmark return, the firm could:
  - Use the actual return of that asset class
  - Use the target return of that asset class
- The firm would disclose this fact as part of the benchmark description
- The firm could label the GIPS Report as preliminary and then update the GIPS Report when the benchmark returns are available

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Highlights From the Revised Guidance Statement on Benchmarks for Firms

- When including a private market investment benchmark as a component of a multi-asset class benchmark, must include a time-weighted return benchmark for this component
  - Cannot combine a time-weighted return with a money-weighted return when calculating a blended benchmark return
- Cost cannot be used as a reason for selecting an inappropriate benchmark

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Survey Report of Firms on GIPS Standards Error Correction Policies

- In 2022, the USIPC and CFA Institute conducted a survey to update the error correction survey from 2014
- Key takeaways include:
  - Firms favor a two-pronged materiality threshold for assessing errors in returns, which includes both absolute and relative terms
  - The most common method for tracking errors is an Excel-based list
  - Approximately 70% of responding firms have either a formal or informal GIPS Standards Oversight Committee
  - More than one-half of the respondents apply an error correction policy to errors that occur outside of GIPS Reports

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Help Desk Questions from the GIPS Standards Newsletter

GIPS Composite Report

- Our firm has a composite that includes an open-end pooled fund and a segregated account. We have decided to present a GIPS Pooled Fund Report to prospective investors for this open-end fund. Should we include in the composite only the segregated account and update the historical figures to remove the open-end fund?

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Help Desk Questions from the GIPS Standards Newsletter

Providing GIPS Reports

- We understand that Provision 1.A.11 requires us to make every reasonable effort to provide a GIPS Composite Report to all prospective clients when they initially become prospective clients. We generally provide the GIPS Composite Report at the time we send our client their fully executed investment management agreement with our firm. Would this practice fulfill the obligation of providing the GIPS Composite Report to all prospective clients when they initially become prospective clients?

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Help Desk Questions from the GIPS Standards Newsletter

Additional Information in a GIPS Report

- A composite has a 15-year GIPS-compliant track record and the firm reports its latest 10 years of annual returns in GIPS Reports. If the firm adds a line for the 15-year since-inception annualized return for the composite and benchmark, must the GIPS Report show each of the 15 individual annual periods or can it show only the 10 annual periods?

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Help Desk Questions from the GIPS Standards Newsletter

Benchmark

- My firm has a US small-cap value fund. This fund is subject to a new SEC requirement to include a broad-based securities market index, in shareholder reports and prospectuses. We have determined that we will present the Russell 3000® Index as the broad-based index for this fund. We include this fund in the US Small-Cap Value Composite. Our firm would like to use the same benchmark in the mutual fund's shareholder reports and the US Small-Cap Value Composite's GIPS Report. We understand that the broad-based index would be considered an inappropriate benchmark under the GIPS standards. Can we add the broad-based index to the composite's GIPS Report as a secondary benchmark and have the broad-based index as the primary index in the fund's shareholder report and prospectus?

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Contact the Presenter

Thomas A. Peters
Investment Industry Group Leader
Director, Investment Industry Group
tpeters@kmco.com

Tom has experience providing audit, Global Investment Performance Standards (GIPS), operational due diligence, and compliance and consulting services to firms in the investment industry. In addition, he:

- Helps clients maintain GIPS compliance while presenting their performance in the best light possible.
- Assists entrepreneurs with starting investment firms and investment funds
- Performs operational due diligence for institutional investors
- Leads fund audits
- Is an active CFA Institute volunteer and has served on several GIPS Committees
- Tom is currently the Chairman of the GIPS OCIO Working Group

As the Investment Industry Group Leader, Tom works with a variety of investment managers, broker-dealers, investment funds, and institutional investors.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Contact the Presenter

Ashley Jiang
Manager, Audit & Accounting,
Investment Industry Group
ajiang@kmco.com

Ashley has experience providing audit and attestation services to investment funds, asset managers, and broker-dealers. She serves clients who manage a wide range of asset classes including equity, traditional fixed income, private placements, private equity, and real estate with various investment structures including hedge funds, funds of funds, and master-feeders. In addition, she provides consulting services including fee recalculation services for traditional and alternative investments.

Ashley performs operational due diligence to assist investors in understanding the operational risk inherent in their investment managers' operations. She also performs custody examinations in accordance with the Securities and Exchange Commission Rule 206(4)-2. Ashley also specializes in performing verifications and composite examinations of investment firms claiming compliance with the Global Investment Performance Standards (GIPS).

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Panel Discussion

The Marketing Rule, Private Fund Rule and Safeguarding Rule

Moderators:

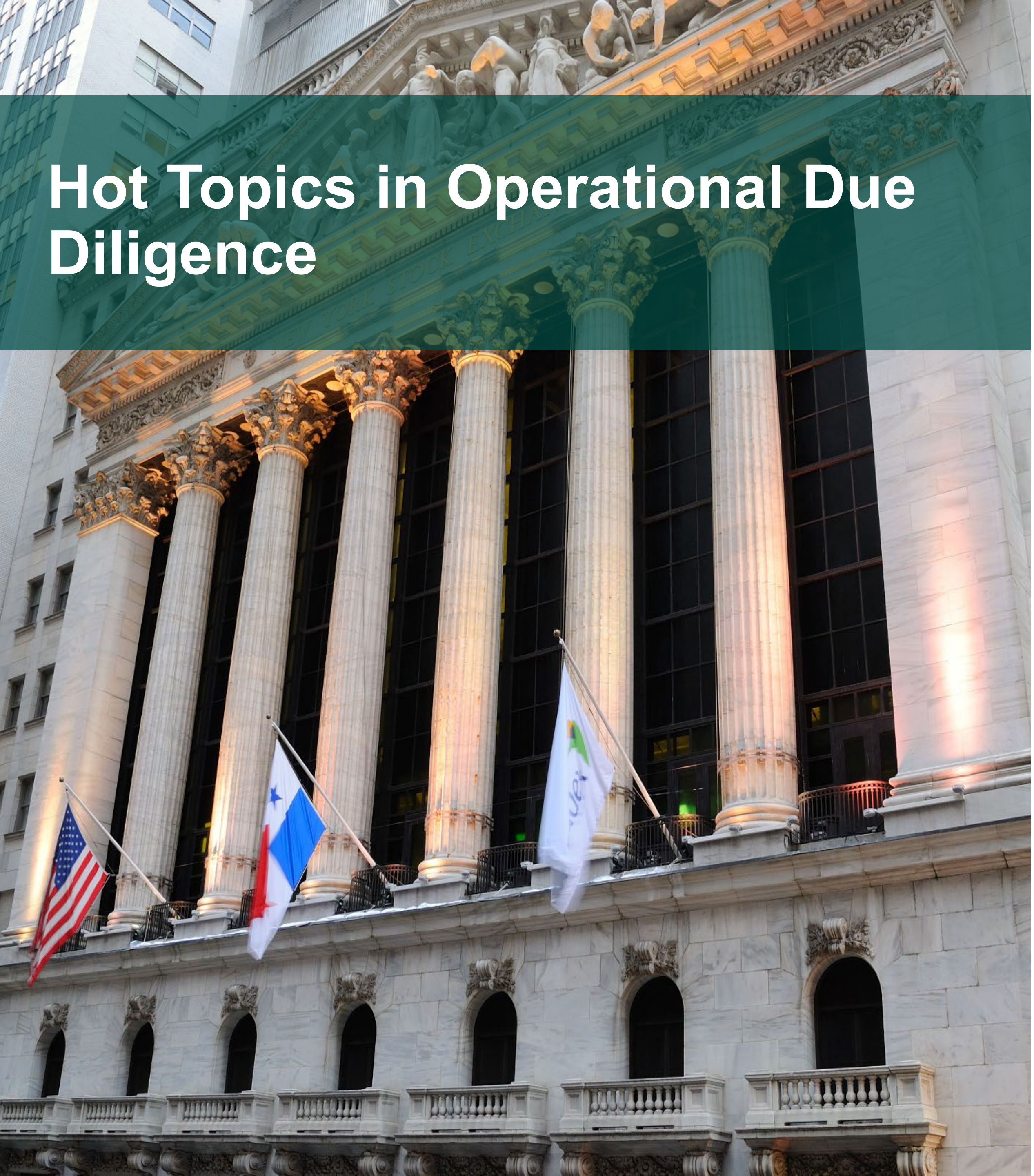
- **Todd Crouthamel**, Director-in-Charge, Audit & Accounting, Kreischer Miller
- **Craig Evans**, Director, Audit & Accounting, Investment Industry Group, Kreischer Miller

Panelists:

- **Michael Beck**, Vice President, Glenmede Trust
- **John Canning**, Director, Chenery Compliance Group
- **Richard Chen**, Managing Partner, Brightstar Law Group
- **Sofia Rosala**, General Counsel and Chief Compliance Officer, Copeland Capital Management, LLC

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS



Hot Topics in Operational Due Diligence

Jen Kreischer,
Director, Audit & Accounting,
Investment Industry Group

www.kmco.com

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Agenda

1. Operational due diligence?
2. Hybrid environment
3. Impact of higher interest rates

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Operational Due Diligence

Operational Due Diligence

- A bespoke, continuous, and iterative process of assessing an investment manager's operational risks across all public and private market asset classes.
- Arms investors with information to assess questions like:
    - Are my assets safeguarded?
    - Are my assets valued correctly?
    - Has the investment manager's firm (IM) acted with integrity and reliability in the past?
    - Can I expect the IM to continue to act with integrity and reliability?

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Operational Due Diligence

- In a 2016 article published by the CFA Institute, Tom Brakke notes that "Due diligence should start by studying asset management organizations and how they work. Qualitative judgments of organizations have taken a backseat to detailed quantitative reviews. Future performance comes from today's organization, yet the 'real' organization may be hidden behind its marketing narrative."
- Recent academic research has shown that qualitative analysis of the information provided to limited partners is more predictive of future results than purely quantitative analysis.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Operational Due Diligence

- Next level of depth to the analysis comes from live discussions with the IM to address specific, current concerns.
- It takes time to get the IM off their "canned speech" into a discussion where the diligence team can learn about their actual philosophies, processes and controls.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Hybrid Environment

Hybrid Environment

- KM’s last presentation on operational due diligence focused on the challenges inherent in a remote environment. We learned from the pandemic, just as the IM’s did.
- IM’s have largely transitioned from remote work in 2020 and some parts of 2021 to a hybrid environment.
- While there may be pressure to keep performing due diligence remotely, it is challenging to learn about the “real” organization in a purely virtual process.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Hybrid Environment

- What factors influence decisions about what to do in person or virtually?
  - Is the assessment critical to your decision?
  - Can you better evaluate processes and systems on-site?
  - Will you have more time to broaden the discussion on-site?
  - Is there confidential information that will only be shared to read, not retain?
  - Have you been provided with detailed information to read and digest?
  - How well do you already know the people and the culture?
  - Have there been significant changes at the IM?

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Hybrid Environment

- What works in a virtual/remote environment?
  - Gathering information to read in advance:
    - Fund documents
    - Presentations
    - Policies and procedures
  - Having questionnaires completed
  - Talking with geographically distant teams via video-conference
- What requires on-site visits for full effectiveness?
  - Assessing tone at the IM, including consistency across teams
  - Sitting with traders to see how their systems actually work
  - Access to some confidential information
  - Building rapport and seeing immediate response to questions

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Impact of Higher Interest Rates

1. Equities
2. Source of debt – private credit?
3. Private equity considerations

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Impact on Equities

- Interest rates may not directly affect stock prices, but they impact the underlying earnings streams.
- The cost of borrowing increases for variable rate loans and for fixed rate loans as they renew.
- Consumers/customers may have less money to spend, decreasing revenue.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Source of Debt – Private Credit?

- Failure of banks (Heartland, First Republic, Signature, Silicon Valley) reduced availability of bank debt
  - Those banks are not available, but regulators and bank leadership have tightened credit at the remaining banks.
- More private credit opportunities
  - Does the IM know how to structure private credit?
  - Fundamental analysis needed on borrowers - coverage ratios, stress test, etc.
  - Appetite for moving up the capital structure.
  - As interest rates shift, are there borrowers that cannot support debt at the current rates?

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Private Equity Considerations

- Have returns shifted on new portfolio companies?
- Impact on economics of existing targe companies
- Costs of initial acquisition increase
- Is growth strategy dependence on future acquisitions?
- Slowing exits from PE fund

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Contact the Presenter

Jennifer L. Kreischer
Director, Audit & Accounting and Investment Industry Group
jlkreischer@kmco.com

Jennifer has over 35 years of experience providing services including due diligence for buyers and sellers, transaction structuring, purchase price adjustment advice, purchase agreement review, and related advisory services. She has advised on a variety of complex transactions, including cross border, carve-outs, recapitalizations, initial public offerings, and rollups.

Jennifer has significant experience performing quality of earnings analysis and operational due diligence. She has led projects to assess M&A process, purchase accounting, and implementation of IFRS for companies in a variety of industries.

Jennifer has a broad range of industry experience, including power and utilities, industrial products, healthcare, service businesses, and industry consolidations.

She is a frequent speaker on due diligence and has facilitated a number of roundtable sessions in the U.S., Canada, and Europe to explore the implications of new accounting standards.

Kreischer Miller
PEOPLE | IDEAS | SOLUTIONS

Break

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Panel Discussion *(continued)*

The Marketing Rule, Private Fund Rule and Safeguarding Rule

Moderators:

- **Todd Crouthamel**, Director-in-Charge, Audit & Accounting, Kreischer Miller
- **Craig Evans**, Director, Audit & Accounting, Investment Industry Group, Kreischer Miller

Panelists:

- **Michael Beck**, Vice President, Glenmede Trust
- **John Canning**, Director, Chenery Compliance Group
- **Richard Chen**, Managing Partner, Brightstar Law Group
- **Sofia Rosala**, General Counsel and Chief Compliance Officer, Copeland Capital Management, LLC

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Tax Update

Richard J. Nelson,
Director,
Tax Strategies

Brian S. Emerson,
Manager,
Tax Strategies

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Agenda

1. Washington and IRS Update
2. Allocation of Capital Gains and Losses
3. Section 1061: Carried Interest
4. Expiring IRS Provisions
5. FINCEN Provisions
6. Withholding Requirements: Form 1042-S

Disclaimer

This material is provided for general informational and educational purposes only and should not be construed as legal or tax advice. You should not rely on information contained in this presentation to make business or tax decisions without first consulting with your tax advisor. The information contained in this material is subject to change without notice. The presenters undertake no obligation to update this material.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Congressional Tax Update

- It’s November—

  Where are we?

  Is Tax even on their minds?

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Congressional Tax Update

Government Priorities Remaining for 2023

Legislative Action	Deadline
Government Funding (appropriations)	November 17, 2023
FAA reauthorization	December 31, 2023
Medicare physician payments	December 31, 2023

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Congressional Tax Update

- Tax doesn’t appear to be a priority. At best a second-tier priority.
- Let's reflect on 2022
- Is 2023 different?

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Republican Bill- American Families and Jobs Act

- Restore 100 percent expensing for investments in equipment
- Restore the 100% expensing of research and development (R&D) costs
- Reduce the current limitation on interest expense (Section 163(j))
- All three would be extended through the end of 2025 and applied retroactively as if they never changed
- Other Provisions:
  - Increase the standard deduction for individuals through 2025
  - Permanently increase the Section 179 expensing

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Republican Bill - American Families and Jobs Act

- To raise additional revenue, the bill would cut back on the Inflation Reduction Act's green energy credits, including repeal or modification of the clean energy production credit, the clean electricity investment credit, the previously owned clean vehicles credit, the clean vehicle credit, and the qualified commercial clean vehicle credit.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Democrats - Issues with Republican Bill

- No increase to the Child Tax Credit
- No increase to the Earned Income Tax Credit
- Eliminate Energy Credits

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Internal Revenue Service Update

- The Internal Revenue Service announced the opening of more than 3,700 positions nationwide in more than 250 locations.
- Effort to expand tax enforcement involving areas of concern with high-income earners, partnerships, large corporations and promoters.
- The hiring will be for higher-graded revenue agents, which are specialized technical positions that generally focus on audits.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Internal Revenue Service Update

- First wave of hiring focused on taxpayer service positions to help improve phone and in-person assistance.
- This wave of hiring will help the IRS add key talent like tax accountants to help reverse a decade-long decline of audits for the wealthy as well as complex partnerships and corporations.
- Focus will be on higher-income and complex tax areas like partnerships, not average taxpayers making less than $400,000.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Internal Revenue Service Update

- Interested individuals in the financial services industry – such as tax accountants, forensic accountants' auditors, controllers and treasurers – can learn more and apply through the job announcement section on the IRS website.
- “This is an exciting time to be at the IRS," said IRS Human Capital Officer Traci DiMartini. "The IRS provides a competitive financial package for people with expertise in this high-demand area. For people with accounting and financial backgrounds, we encourage them to take a close look at the benefits of working for the IRS and serving our nation.”

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Partnership Audits

- The IRS began focusing on examinations of the largest and most complex partnership returns through its Large Partnership Compliance pilot program launched in 2021.
- They plan to expand the program to additional large partnerships, using AI to select returns for examination.
- On September 8th, the IRS stated that it plans, by the end of the month, to have opened examinations of 75 of the largest partnership in the U.S. in a cross section of industries – including hedge funds, real estate investment partnerships, publicly traded partnerships, and large law firms.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Partnership Audits

- New Centralized Partnership Audit Rules enacted in 2015.
- Increased focus on partnership compliance including Schedules K-1, K-2 and K-3.
- IRS has identified ongoing discrepancies in balance sheets of partnerships with over $10 million in assets. Discrepancies in balances between the end of one year and the beginning of the next year – many in the millions of dollars, without any required attached statement explaining the discrepancy.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Partnership Audits

- Using its new resources, the IRS plans to mail out compliance letters to around 500 partnerships starting in early October. Depending on the partnerships' responses, the IRS might take additional action, including potential examination.
- What can you do?

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Employee Retention Credit

- Credit for Wages paid in 2020 and 2021
- Qualifying Tests:
  - Quantitative based upon percentage deduction in revenue.
    - In 2020 50% reduction in revenue compared to same quarter in 2019.
    - In 2021 20% reduction in revenue compared to same quarter in 2019
  - Were your operations fully or partially suspended due to a government ordered shutdown?

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

IRS Warnings

- Urge people to review guidelines before trying to claim the credit.
- Credit promoters on the radio and online continue to push ineligible people to file.
- The IRS has been issuing warnings about aggressive ERC scams since last year, and it made the agency's list this year of the Dirty Dozen tax scams that people should watch out for.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Recent IRS Announcements on ERC

- Announced an immediate moratorium through at least the end of the year on processing new claims for the pandemic-era relief program.
- On July 26, the agency announced it was shifting its focus to review these claims for compliance concerns, including intensifying audit work and criminal investigations on promoters and businesses filing dubious claims.
- On September 14th the IRS announced that hundreds of criminal cases are being worked, and thousands of ERC claims have been referred for audit.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Recent IRS Announcements on ERC

- IRS issued guidance on withdrawing a claim
- Different steps depending on where you are in the process:
  - You haven't received a refund and haven't been notified your claim is under audit.
  - You haven't received a refund and you've been notified your claim is under audit.
  - You received a refund check but haven't cashed or deposited it.
  - Still working on guidance if you cashed the check but want to return it.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Recent IRS Announcements on ERC

- The credit is a good thing if you qualify. There is still time to apply for the credit.
- For 2020 can file amended payroll tax returns until April 15, 2024.
- For 2021 can file amended payroll tax returns until April 15, 2025.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Allocation of Capital Gains and Losses

- Aggregation Methods – (reverse 704(c) allocations)
  - Partial Netting
  - Full Netting
  - Both methods involve a revaluation account.
- Layering
  - Offers accuracy but very time consuming
- Any reasonable approach to aggregation that is consistent with § 704(c).

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Allocation of Capital Gains and Losses

Full Netting

- Maintain a revaluation account for each partner.
- Net tax gains and losses are combined.
- The revaluation account is increased/decreased by book allocations of gains and loss.
- Gains are first allocated to partners with a positive balance and excess allocated pro rata to all partners.
- Losses are first allocated to partners with a negative balance and excess allocated pro rata to all partners.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Allocation of Capital Gains and Losses

Full Netting – Example:

	Book Capital Account	Book Income/(Loss)	Adjusted Book	Tax Capital	Net gain/loss	Total	Revaluation	Book Allocation	Adjusted Revaluation	Net Realized	Revaluation Account
Partner A	15,250	(100)	15,150	15,000	(33)	14,967	250	(100)	150	(33)	183
Partner B	15,250	(100)	15,150	15,000	(33)	14,967	250	(100)	150	(33)	183
Partner C	15,250	(100)	15,150	15,250	(134)	15,116	-	(100)	(100)	(134)	34
Total	**45,750**	**(300)**	**45,450**	**45,250**	**(200)**	**45,050**	**500**	**(300)**	**200**	**(200)**	**400**

The book loss is $300 after C joins the partnership
The partners own 1/3 each of ownership

Tax Realized Gain	200
Tax Realized Loss	-400
Unrealized Loss	-100
Book Income/Loss	**-300**

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Allocation of Capital Gains and Losses

Partial Netting

- Maintain a revaluation account for each partner.
- Tax gains and losses are combined separately.
- The revaluation account is increased/decreased by book allocations of gains and loss .
- Gains are first allocated to partners with a positive balance and excess allocated pro rata to all partners.
- Losses are first allocated to partners with a negative balance and excess allocated pro rata to all partners.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Allocation of Capital Gains and Losses

Partial Netting – Example:

	Book Capital Account	Book Income	Adjusted Book	Tax Capital	Gain	Loss	Total	Revaluation	Book Allocation	Adjusted Revaluation	Realized Gain	Realized Loss	Revaluation Account
Partner A	15,250	(100)	15,150	15,000	100	(100)	15,000	250	(100)	150	100	(100)	150
Partner B	15,250	(100)	15,150	15,000	100	(100)	15,000	250	(100)	150	100	(100)	150
Partner C	15,250	(100)	15,150	15,250	-	(200)	15,050	-	(100)	(100)		(200)	100
Total	**45,750**	**(300)**	**45,450**	**45,250**	**200**	**(400)**	**45,050**	**500**	**(300)**	**200**	**200**	**(400)**	**400**

The book loss is $300 after C joins the partnership
The partners own 1/3 each of ownership

Tax Realized Gain	200
Tax Realized Loss	-400
Unrealized Loss	-100
Book Income/Loss	**-300**

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Allocation of Capital Gains and Losses

Layering

- Assumes each partner purchases a pro rata share of each security position owned by the partnership at the time when the partner joins the partnership.
- Track historical layers of gain/loss for each security by partner for the period of time that the partnership owns the security.
- When the security is sold, the gain is allocated based on historical ownership of the security using each layers unrealized gain.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Allocation of Capital Gains and Losses

Stuffing

- Allocation of gains to a partner leaving the partnership in excess of the allocated gain.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Section 1061: Carried Interest

What is carried interest?

- A practice designed to grant what would otherwise be compensation to hedge fund managers in the form of ordinary income into long-term capital gains by assigning such managers a profits interest, with allegedly no value, and allowing it to ripen into a share of long-term gains when those gains are realized.

- Governs how certain long-term capital gains allocable to Applicable Partnership Interests may be recharacterized as short-term capital gain if holding period is less than 3 years.
  - Change made as a result of TCJA passage in 2017
  - Years beginning after 12/31/17 saw holding period shift from 1 to 3 years

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Section 1061: Carried Interest

Background

- A pass-through entity's income and loss items are allocated to its limited partners based on their allocable share of contributions to the fund, adjusted for any future distributions.
- General Partners are typically paid a management fee on committed capital.
- Carried interest is a share of profits earned within private equity, venture capital, & hedge funds specifically allocated to general partners of private equity, venture capital, hedge funds, etc.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Section 1061: Carried Interest

Carried interest differs from a management fee:

- Management fee – Paid to GP's and is based on a percentage of committed capital
- Carried Interest – Considered a performance fee
  - Aligns compensation of the GP with the overall performance of the fund and is only paid when the fund reaches predetermined rates of return (Hurdle rates)

Benefits:

- Additional form of compensation to GP
  - GP passes gains out to individual fund managers via K-1's
- Carried Interest typically qualifies for treatment as long-term capital gains rather than ordinary income
  - LTCG tax rate – 20% Max
  - Ordinary Individual income tax rate – 37% Max

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Section 1061: Carried Interest

Following Capital Gains not taken into consideration for 1061:

- Section 1231 long-term capital gain/loss (property used in trade or business)
- Section 1256 long-term capital gain/loss
- Qualified Dividends included in net capital gains
- Capital gains and losses characterized as short-term/long-term without regard to typical holding period rules

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Section 1061: Carried Interest

Applicable Partnership Interest

- Only applies to capital gain allocations made in relation to an applicable partnership interest (API)
  - Defined as any interest in a partnership which is transferred to or held by the taxpayer in connection with the performance of substantial services by the taxpayer in any applicable trade or business (ATB)

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Section 1061: Carried Interest

Applicable Partnership Interest does not include:

- Any interest in a partnership directly or indirectly held by a corporation
- Any capital interest in the partnership which provides the taxpayer with a right to share in capital commensurate with:
  - the amount of capital contributed (determined at the time of receipt of the partnership interest)
  - the value of such interest subject to tax under § 83 upon the receipt or vesting of such interest

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Section 1061: Carried Interest

Look-Through Rules

- Final regulations limit the application of the Look-Through Rule to situations where, at the time of disposition of an API held for more than three years:
  - the API would have a holding period of three years or less if the holding period of such API were determined by not including any period prior to the date that an Unrelated Non-Service Partner is legally obligated to contribute substantial money or property directly or indirectly to the Pass-Through Entity to which the API relates (this rule does not apply to the disposition of an API to the extent that the gain recognized upon the disposition of the API is attributable to any asset not held for portfolio investment on behalf of third party investors)
  - a transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under section 1061(a)

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Section 1061: Carried Interest

Look-Through Rules (*continued*)

- Implemented to prevent fund managers from opening partnerships and leaving them inactive for 3 years before trying to add LP's and contributions.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Looking Forward

Expiring Tax Provisions:

- Effective December 31, 2025 the Tax Cuts and Jobs Act provisions are set to expire and revert to 2017 law unless extended, revised, or made permanent.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

2023 Federal Income Tax Rates

Tax Rate	Joint/Surviving Spouse	Single	Head of Household	Married Filing Separately
10%	$0 – $22,000	$0 – $11,000	$0 – $15,700	$0 – $11,000
12%	$22,001 – $89,450	$11,001 – $44,725	$15,701 – $59,850	$11,001 – $44,725
22%	$89,451 – $190,750	$44,726 – $95,375	$59,851 – $95,350	$44,726 – $95,375
24%	$190,751 – $364,200	$95,376 – $182,100	$95,351 – $182,100	$95,376 – $182,100
32%	$364,201 – $462,500	$182,101 – $231,250	$182,101 – $231,250	$182,101 – $231,250
35%	$462,501 – $693,750	$231,251 – $578,125	$231,251 – $578,100	$231,251 – $346,875
37%	Over $693,750	Over $578,125	Over $578,100	Over $346,875

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

2024 Federal Income Tax Rates

Tax Rate	Joint/Surviving Spouse	Single	Head of Household	Married Filing Separately
10%	$0 – $23,200	$0 – $11,600	$0 – $16,550	$0 – $11,600
12%	$22,201 – $94,300	$11,601 – $47,150	$16,551 – $63,100	$11,601 – $47,150
22%	$94,301 – $201,050	$47,151 – $100,525	$63,101 – $100,500	$47,151 – $100,525
24%	$201,051 – $383,900	$100,526 – $191,950	$100,501 – $191,950	$101,526 – $191,950
32%	$383,901 – $487,450	$191,951 – $243,725	$191,951 – $243,700	$191,951 – $243,725
35%	$487,451– $731,200	$243,726 – $609,350	$243,701 – $609,350	$243,725 – $365,600
37%	Over $731,200	Over $609,350	Over $609,350	Over $365,600

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Expiring IRS Provisions

Individual Income Tax Rates:

- Tax rates will revert to percentages last enacted in 2017.

2024	Projected 2026 Tax Rates
10%	10%
12%	15%
22%	25%
24%	28%
32%	33%
35%	35%
37%	39.6%

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Expiring IRS Provisions

Itemized Deductions:

- The increased standard deduction enacted under the TCJA are set to decrease.
- Personal exemptions previously eliminated will return as the TCJA provisions expire.
- The limitation of state and local taxes paid will be removed allowing a full deduction.
  - Previously capped at $10,000 for Married Filing Joint (MFJ) and $5,000 for individuals Married Filing Separate (MFS)

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Expiring IRS Provisions

Qualified Business Deduction:

- The pass-through entity 20% deduction or commonly known as Section 199A deduction will sunset effective January 1, 2026.

	Tax Years 2023 through 2025	2026 Tax Year
Business Income	$ 1,000,000	$ 1,000,000
Qualified Business Deduction (20%)	20%	-
Total Section 199A Deduction	**$ (200,000)**	**$ -**
Taxable Business Income	$ 800,000	$ 1,000,000
Projected Tax at Highest Tax Rate	**296,000**	**396,000**
	37.0%	39.6%

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Expiring IRS Provisions

Lifetime Estate and Gift Exemption:

- Beginning in 2024, the federal and gift tax exemption will increase to **$13,610,000** or **$27,220,000** for a married couple (up $690,000 from 2023).
- As a result of the sunset provision, the exemption will revert to approximately **$6,000,000**.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Beneficial Ownership, New Compliance Requirements

- Established by the Corporate Transparency Act “CTA”
- Requires business entities to identify to the Treasury Department individuals who own 25%* or greater interest, and individuals who exercise substantial control over the company
- New informational filings required in 2024
- Entities formed before 2024 have until Jan 1, 2025 to file
- Entities formed after 2023 will be required to file within 30 days of registration

* Directly or indirectly

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Beneficial Ownership, New Compliance Requirements

- Filing requirement will generally apply to every entity with $5 million or less in annual US revenues or 20 or less full-time US employees.
- Changes in information must be promptly reported (within 30 days).

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Beneficial Ownership, New Compliance Requirements

- There are 23 exemptions, some of which are:
  - Any broker or dealer, as defined in section 3 of the Securities Exchange Act of 1934, that is registered under section 15 of that Act (15 U.S.C. 78o)
  - Securities exchanges or clearing agencies as defined in section 3 of the Securities Exchange Act of 1934, and that is registered under sections 6 or 17A of that Act
  - Certain other types of entities registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934
  - Certain types of investment companies as defined in section 3 of the Investment Company Act of 1940, or investment advisers as defined in section 202 of the Investment Advisers Act of 1940

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Beneficial Ownership, New Compliance Requirements

- There are 23 exemptions some of which are (continued):
  - Certain types of venture capital fund advisers.
  - Certain pooled investment vehicles
  - Large operating companies with more than 20 full-time employees, more than $5,000,000 in gross receipts or sales, and an operating presence at a physical office within the United States

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Beneficial Ownership, New Compliance Requirements

Who is a beneficial owner?

- In general, a beneficial owner is any individual (1) who directly or indirectly exercises "substantial control" over the reporting company, or (2) who directly or indirectly owns or controls 25 percent or more of the "ownership interests" of the reporting company.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Beneficial Ownership, New Compliance Requirements

- This is not reported to the IRS. This goes to FinCEN, U.S. Department of the Treasury, Financial Crimes Enforcement Network
- The willful failure to report complete or updated beneficial ownership information to FinCEN, or the willful provision of or attempt to provide false or fraudulent beneficial ownership information may result in a civil or criminal penalties, including civil penalties of up to $500 for each day that the violation continues, or criminal penalties including imprisonment for up to two years and/or a fine of up to $10,000. Senior officers of an entity that fails to file a required BOI report may be held accountable for that failure.

- Beneficial Ownership Information Reporting | FinCEN.gov

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Private Fund Managers Petition Tax Court on Self-Employment Tax Issue

- In *Soroban Capital Partners LP v. Commissioner,* the key issue is whether limited partners in state law limited partnerships may claim exemption from SECA taxes – despite being more than passive investors. Case is close to resolution in the Tax Court.
- Two additional Tax Court petitions with similar issues were recently filed by private fund managers challenging IRS assessments of self-employment (SECA) tax on limited partners in fund management companies. The cases – *Point 72 Asset Management LP v. Commissioner* and *Denham Capital Management LP v. Commissioner*. Court.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Private Fund Managers Petition Tax Court on Self-Employment Tax Issue

- The IRS's audit campaign has been targeting limited partners who, in the IRS's view, are active participants in the operations of the management company and thus not entitled to the SECA tax exemption. The IRS has asserted that the determination of limited partner status is a "facts and circumstances inquiry" that requires a "functional analysis".
- The issue has not yet been specifically addressed by the courts.
- The IRS has audited a large number of fund managers in recent years and in many instances assessed SECA taxes.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

New Form 1042-S Instructions

- Generally, a non-citizen is subject to U.S. tax on income from U.S. sources.
- Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, is used to report amounts paid to foreign persons by a United States based institution or business. This applies to non-resident aliens, foreign partnerships, foreign corporations, foreign estates, and foreign trusts that are subject to income tax withholding.
- Withholding agents file Form 1042-S to report amounts paid to foreign persons including but not limited to: dividends paid by American corporations, royalties, income from real estate, interest on deposits and compensation for personal services performed in the U.S.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

New Form 1042-S Instructions

- The rules are complex. The instructions to the form are 43 pages long and contain numerous references to Internal Revenue code sections.
- There are also exemptions defined by statute and in separate foreign country treaties.
- Penalties related to form 1042-S continue to rise. Withholding agents may be liable for penalties and interest if the form is filed late or if the wrong form is filed.
- Most of the changes are for publicly traded partnerships (PTPs).

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

New Form 1042-S Instructions

- Income code 57 – Starting for 2023, brokers required to report amounts realized and related withholding from transfers of PTP interests
- Income code 58 – For nominees to report on form 1042-S when they are unable to determine the characterization of income associated with a PTP distribution
- Chapter 3 status code 39 – Used when a broker, PTP, or nominee makes a payment of an amount realized or PTP distribution to a Qualified Intermediary acting as a disclosing Qualified Intermediary

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Contact the Presenter

Richard J. Nelson
Director, Tax Strategies
rnelson@kmco.com

Rich is a Director in Kreischer Miller's Tax Strategies group. has extensive experience providing domestic and international tax strategies, planning and services to a variety of middle market companies and entrepreneurial businesses in a number of industries including manufacturing, distribution, real estate, financial, and professional services. He also has significant experience and expertise with high-net-worth individuals, investment companies and pass-through entities and has been involved in federal, state, and local tax audits, settlements, and appeals.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

Contact the Presenter

Brian Emerson
Manager, Tax Strategies
bemerson@kmco.com

Brian is a Manager in Kreischer Miller's Tax Strategies group. Brian has a diversified range of experience providing services to a variety of companies in the real estate, investment, manufacturing, distribution, and service industries. He provides a variety of tax services and strategies, including tax compliance, tax planning, and tax research for multi-state companies, corporations, partnerships, trusts, and high-net-worth individuals. He is also a member of the firm’s Investment Industry Group.

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS

About Kreischer Miller

Kreischer Miller is an accounting, tax, and business advisory firm that has been serving clients since 1975. Kreischer Miller's Investment Industry Group provides GIPS compliance, operational due diligence, and audit and tax services for investment firms and asset owners. Kreischer Miller's Investment Industry Group has experience working with firms across the U.S. and Europe in a variety of asset classes. **Learn more at kmiig.com.**

PEOPLE | IDEAS | SOLUTIONS

Thank You!

Kreischer Miller

PEOPLE | IDEAS | SOLUTIONS