Elucidating the concept of Direct Tax Due Diligence

In the last decade, two revolutions have produced breakthrough advances in business productivity – Computerisation and Communication. Now, bolstered by the gains of first two advances, we have entered the third revolution – Collaboration.

Collaboration is the need of the hour. Entrepreneurs now are striving for collaborations to enhance value of their business, achieve consolidation and synergy in operations.

In today's changing business dynamics, inorganic expansion is no longer an option but a survival strategy for business houses.

Need for Tax Due Diligence

When management decides to acquire or merge, or a strategic fund decides to invest, it becomes imperative that among other things it should be aware of the leadership, strategies and policies, valuations, future plans, working environment, recorded and unrecorded liabilities and assets, existing and potential litigations, etc., of the investee's business.

Due diligence is focussed to unearth such strategies, future plans, unknown liabilities, assets, litigations, etc. and thus assist in deciding the viability of the proposal.

As the name suggests, tax due diligence (hereinafter referred to as "Tax DD") involves appraising and evaluating the tax environment of an entity. It aids in finding answers to questions like - Is the tax policy of the entity aggressive or conservative? How much are the tax losses of the entity? Are they eligible for carry forward and set off? When does the tax losses lapse? How much tax liability is the entity sitting on? How much potential tax exposure the entity may suffer due to its past tax treatment of transactions? Is entity enjoying any tax holiday and is it eligible to do so? How much is the tax exposure of the pending litigations of the entity and how much is the likeliness of winning or losing them? What are the potential tax litigations? What will be the transaction taxes depending on the structure of the Target and the mode of acquisition? Is the current deal of merger, etc. likely to be challenged by the tax authorities?

Typically, a Tax DD is called for by the investor/ buyer in case of transactions like mergers, acquisitions, substantial investments, takeovers, listing etc. A regulatory authority may also order Tax DD of an entity in the process of an investigation. Understanding and evaluating the tax positions of the entity (hereinafter referred to as the "Target") assumes greater importance in today's scenario since corporates are following different and aggressive tax practices (having frivolous holding structures, taking advantage of loopholes in tax law to evade tax, etc.) and the Indian Revenue Authorities are coming out with new laws to challenge and negate such aggressive tax positions.

Accordingly, Tax DD plays a very important role, firstly in deciding whether to proceed with the deal or not, depending on the quantum and degree of tax exposure and secondly, if the parties agree to proceed then what should be the adjustments in the purchase consideration for the tax exposures.

Approaches to tax due diligence

Depending on Investor's comfort and other commercial reasons, Tax DD process may range from a very high level summarised Tax DD limited to interview with management of the entity to a very detailed and comprehensive process involving analyses of all relevant documents over a period of few years (hereinafter referred to as “review period”). For e.g. where the investor is confident of the earlier management’s tax decision making or is a related party/ group company, he may agree to a high level Tax DD.

In addition, a Tax DD may also be performed in a phased manner where on the basis of result of a summarised Tax DD, it may be decided whether to go in for a more detailed exercise.

Below are mentioned few commonly applied approaches to Tax DD:

- A high level interview with management to assess the tax environment and important tax exposures
- An interview with management to assess the tax environment and review of only preliminary documents. Only limited discussion with the management on the issues found.
- A detailed and comprehensive review of the documents relevant to the process of Tax DD and discussing the issues with the management

Procedure

Foremost, the tax consultant undertaking the Tax DD needs to make himself familiar with the business of the Target, the industry it is operating in, size and nature of operations, the group structure, stakeholders and their tax residence status, customers, suppliers and other related parties. He may also need to acquaint himself with the typical issues faced by the industry in which the entity is operating. This becomes particularly important in case of super specialised industries like Aviation, Insurance, etc.

Preliminary documents to be analysed for the review period:

- Audited and provisional financial statements
- Income tax returns (“ITR”) and corresponding computations
- Tax audit reports
- Certifications for computation of income under MAT regime, Mat credit, if applicable
- Transfer pricing reports, if applicable
- Other regulatory approvals obtained
- Documents evidencing registrations for Tax holidays
- Notice for assessments, demands, etc.
- Any notice issued under Section 281B of the Income Tax Act, 1961 (hereinafter referred to as “the Act”) attaching any property of the entity for recovery of tax
- Assessment and appellate orders, all documents in relation to pending litigations, opinions obtained
- Wealth tax returns, if applicable

Following few points should be kept in mind while undertaking Tax DD:

- **Reconciliation of all documents -** It should be ensured that the information disclosed in one document should be in sync with all other documents. For example, an expense added back for computation of taxable income on account of Section 43B of the Act should be reported in Tax audit return also. Similarly all expenses reported to be disallowed in tax audit report should also have been added back to profits to determine taxable income.

- **Timely filing of Income Tax Return -** It should be checked whether ITRs were filed in time, particularly, in case of loss returns.

- **Eligibility of tax holidays -** In case the target is enjoying a tax holiday, it needs to be ensured that it is eligible for the same and requisite approvals and certificates have been obtained. For e.g., eligibility to tax holiday may be questioned when the target was incorporated/ set up by restructuring of an existing entity.

- **Verification of brought forward tax losses –** It should be ensured that the tax losses carried forward are genuine and unquestionable. Further, the time period for carry forward and set off of losses should not have lapsed.

- **DTA / DTL reconciliation –** The consultant should verify the workings of DTA and DTL and report the reasons (along with their quantum effect) of creation of DTA and DTL.

- **Tax provisioning –** The consultant should also verify the correctness of tax provision debited in profit and loss account of the entity.

- **Litigations –** Any pending litigations should be examined and the likeliness of the target winning such litigations should be assessed on the basis of the arguments taken by the target, past judicial precedents, etc. The tax consultant should highlight the risk profiling of all the pending litigations and quantify the tax liability including interest and penalty that may accrue if target loses. In addition, he should also highlight any penalty or prosecution order served on the entity in relevant past.

- **Investigations –** The consultant should check for any investigations undertaken on the entity like search, survey etc. The same should be highlighted in the Tax DD report. Important findings of such investigation should also be highlighted.

- **Transfer Pricing –** In case of substantial transactions with international associates, the consultant should report on the adequateness and completeness of transfer pricing returns and records.

- **Past reorganisations –** Depending on the scope of Tax DD, any past reorganisations may be analysed and corresponding potential tax liability may be highlighted.

Last, but not the least, the tax consultant should analyse and comment on the tax environment of the entity - whether aggressive or conservative. The same may be judged from interaction with the target's management, analysis of the tax policies and treatments adopted in past, etc.

Deal issues

Besides undertaking the normal procedure, tax implications of the proposed deal should also be analysed and highlighted.

For example, if the transaction in question is acquisition, then the consultant should throw some light on tax aspects to be kept in mind while finalising the deal, viz:

- Lapse of losses under Section 79 due to change in shareholding
- Capital gain tax implications
- Continuation of tax holidays post acquisition
- Risk under Section 281 of the Act for holding the current transaction as void in nature
- Risk of indirect transfer akin to Vodafone issue and withholding tax liability under Section 195 of the Act, in case of non-resident transferees
- Possible tax planning and restructuring
- Any other tax issue

Consultant's perspective

- **Defined Scope of wor**k **-** It is important for the consultant to ensure that the scope of work of Tax DD is clearly defined. To avoid any altercation, it is best that the scope of work should be documented (including fee agreed, review period) and signed by both the parties before start of the due diligence process.

- **Materiality level** – The consultant should also decide on a materiality level with the Target's management. Materiality level may be decided for the taxable income or the tax impact. Exposures below the materiality level are generally not covered as part of the scope. Adherence to a materiality level ensures that the Tax DD report does not contain trivial and petty observations since these may dilute the significance of the report.

- **Pending information -** Information pending as on the date of issue of the Tax DD Report should be clearly mentioned in the Report itself. This is needed for two reasons:
  - Top management would be informed about the information not provided by the company
  - The consultant will be safeguarded from any exposure / issues emanating from lack of information / non availability of such documents

  Consultant should also clearly mention the documents reviewed by him during the Tax DD process. Further, management representations and confirmations should be obtained wherever required i.e. where the documents provided contrary information or some ambiguity exists. In addition, all oral confirmations obtained during the Tax DD process should be documented in the final Report.

- **Disclaimers** – It is extremely important that the Consultant provides for proper disclaimers / caveats in the Report limiting his risks and liabilities arising from the Report. Such caveats may include:
  - The purpose of the tax review is not to express an opinion or provide an advice.
  - It is not possible to highlight exposures, which could be identified by detailed review of books of accounts, Groupings & Trial Balances and correspondence with the tax authorities.
  - Income Tax Authorities may take a different view from consultants
  - Review does not include review of the following taxes viz social security tax, tax collection at source, wealth tax, withholding tax review, etc. (as applicable)

Other

Depending on the scope and comprehensiveness of the Tax DD, following may also be added to the report:

- **Background of Target** - A brief background on the Target may be provided on the business of the target, total turnover, Industry it is operating in, general trends in that industry, recent changes in the Industry dynamics, opportunities and challenges faced by the Industry, etc.

- **Quantification of risk wherever possible** – This would include quantifying the tax exposure (including interest and penalty) for issues highlighted. In such case, cut-off date considered for computation of interest should also be provided. Generally, penalty is computed at 100% of the tax exposure, though the same may be mentioned

- **Risk rating** – All issues may be summarised along with their potential tax exposure and classified at one place as high, medium and low risk. The same would give the top management a bird eye view of the tax issues involved and their graveness

- **Temporary / Permanent effect** – It is imperative to mention while reporting an issue, whether the tax effect of the same would have a temporary difference or permanent difference in future. In case it has temporary difference, then the economic risk of the issue would decrease significantly since the difference would reverse in the future.

- **Presentation** – The consultant may consider presenting comprehensive and significant information in charts and tables to enhance the utility of the Tax DD report. For e.g., following information regarding litigations, key issues found, etc. may be presented in tabular form:

  - <u>Existing and potential litigations:</u>
    - Issue
    - Current status i.e. the appellate authority hearing the case
    - Tax exposure involved (including interest and penalty)
    - Risk profiling – likeliness of winning

  - <u>Key issues:</u>
    - Issue
    - Potential tax exposure involved (including interest and penalty)
    - Risk profiling
    - Risk of litigation
    - Temporary / permanent effect

- **Points to be remembered when addressing foreign management**: Where the Tax DD report is issued to a foreign management, it would be significant for the consultant to take care of the following:
  - Mentioning figures in dollars, euro, etc., as the case may be
  - Following international decimal system
  - Expressing figures in thousands, millions
  - Mentioning exchange rate applied to convert rupee into foreign currency
  - Using universal terminologies wherever possible

Since, tax exposure plays a very important role in a transaction and may even break a deal if not addressed appropriately, it is imperative for the Consultant to undertake the Tax DD process with utmost attention. He should also endeavour to continuously update himself with the latest laws and judicial views and practically apply them in the Tax DD process.

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