Due Diligence – Direct Tax

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Due Diligence – What is it?

Types of Due Diligence

- <u>**Internal team**</u>
- <u>**Commercial & operational**</u>
  - The review is generally performed by the internal team of the acquirer who establish the synergies accruing from the transaction. This evaluation is done from a commercial, strategic and an operational perspective.
- <u>**External Experts**</u>

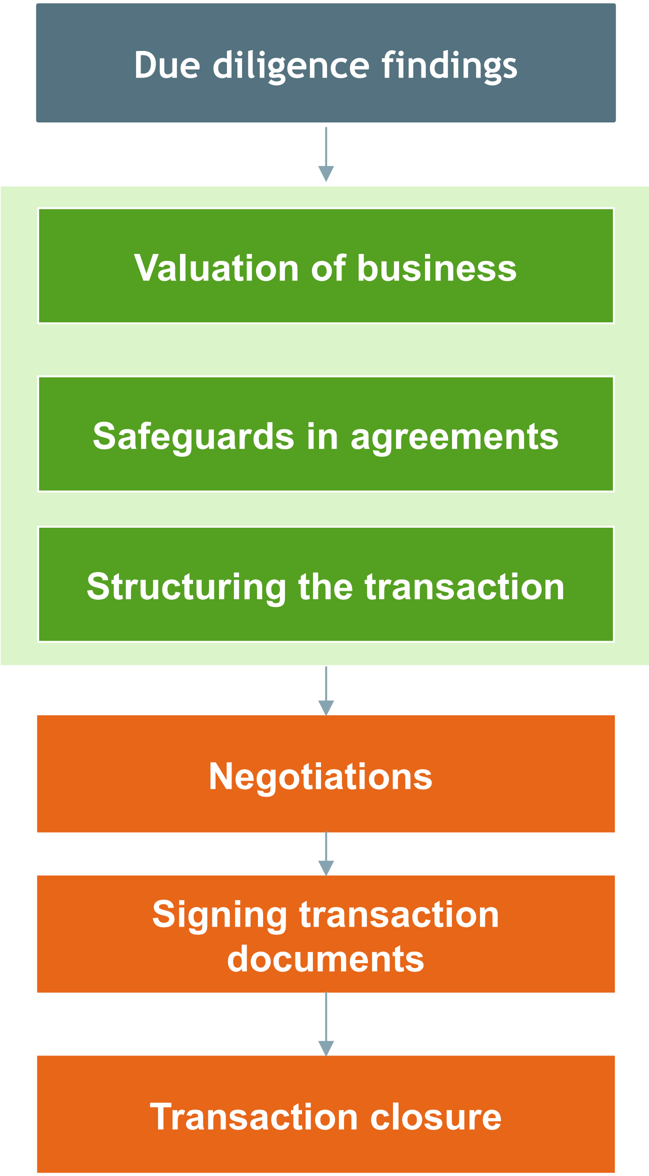
Types of Deal

Focus and information requirements for tax DD differ significantly

Types of Due diligence - Scope of work

Framework

Objectives (1/3)

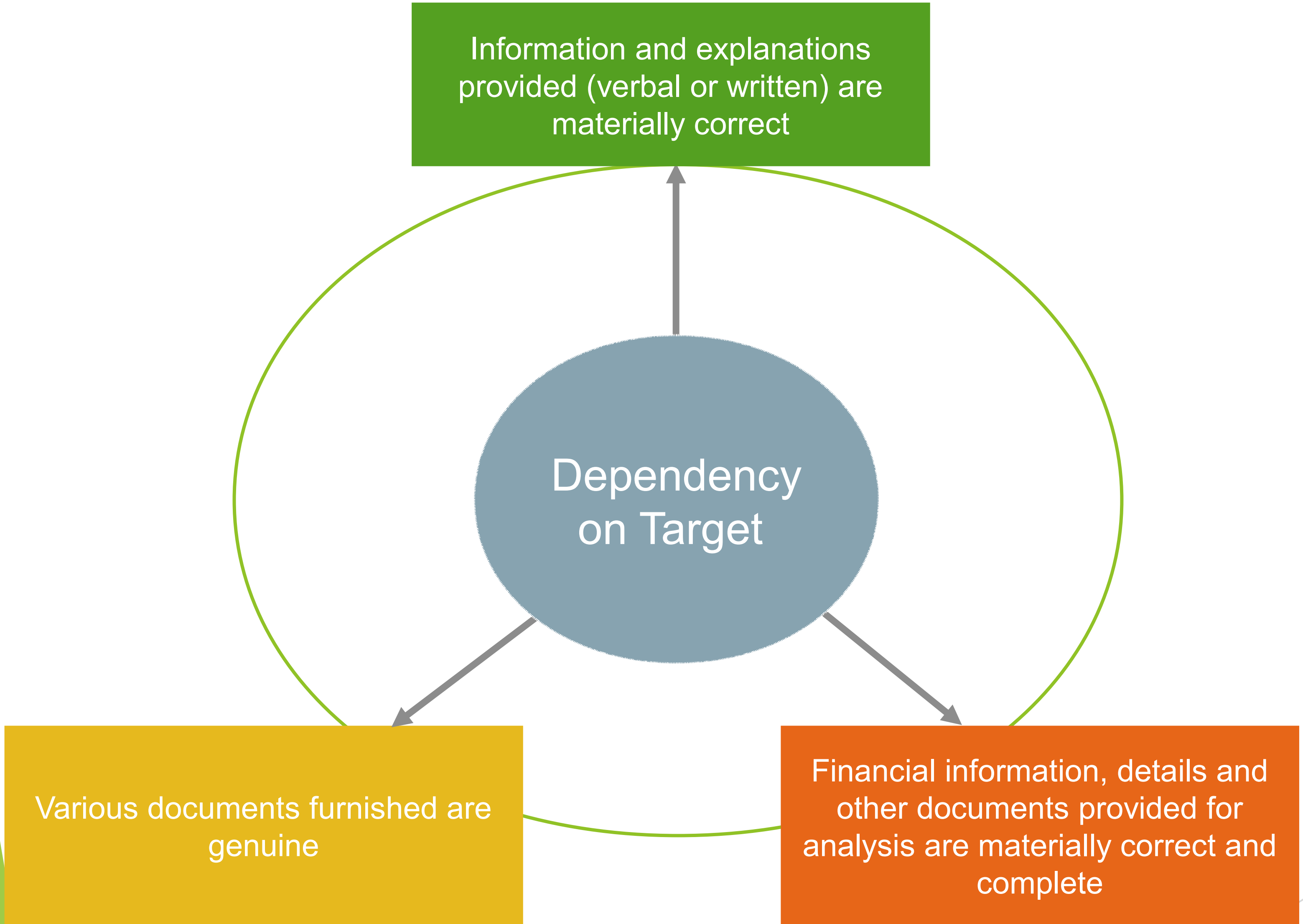


- Due diligence - maps the way forward for transaction closure
- Due diligence findings form the basis of valuation of the target
- Indemnities and conditions precedents incorporated in the agreements based on due diligence exercise
- Due diligence findings aids in negotiating for a better price

Objectives (2/3)

Objectives (3/3)

Limitations



Due diligence - Broad process

Structuring the deal in a tax efficient manner (including suggestion on tax efficient structures) can be undertaken based on findings of due diligence

Planning a tax Due diligence

Understanding industry issues	· Acquire knowledge of industry · Garner industry specific tax issues
Understanding basis of valuation	· Net assets value - Focus on tax assets, tax advances and tax provisions · Future cash flows of Target - Focus on tax issue that may have a future tax outflow and issues likely to recur in future · PE multiple (Multiple of net profit of Target) - Focus on tax provisions
Understanding the deal structure	· Share deal vs. Asset Deal
Determining materiality level	· Quantitative parameters - Tax exposure vis-à-vis PBT / PAT of Target - Tax exposure vis-à-vis overall tax cost of Target - Recurring issue or one time issue · Qualitative parameters - Occurrence of survey, search and seizure in Target premises in past - Occurrence of special type of assessments (viz. block assessments, re-assessments) - Occurrence of settlement with tax authorities (viz. through settlement commission)

Stock Deal - Critical indicative areas for consideration - Direct tax (1/2)

Tax returns	• Filings within due date • Computation of income, disclosures and adopted positions • Disclosures in the tax audit report • Computation of MAT or AMT • Set off of brought forward losses and unabsorbed depreciation
Assessment and appeal status	• Assessment orders • Litigations • Open years for assessment • Submissions made to appellate authorities • Impact of litigation on subsequent years • Probability of exposures
Tax holiday / incentives	• Eligibility to claim tax incentives and compliance with conditions attached thereto • Apportionment of expenses and postponing expense recognition • Impact of transfer of undertaking claiming tax incentives
Tax & book losses	• Break down of tax and book losses into business loss and unabsorbed depreciation

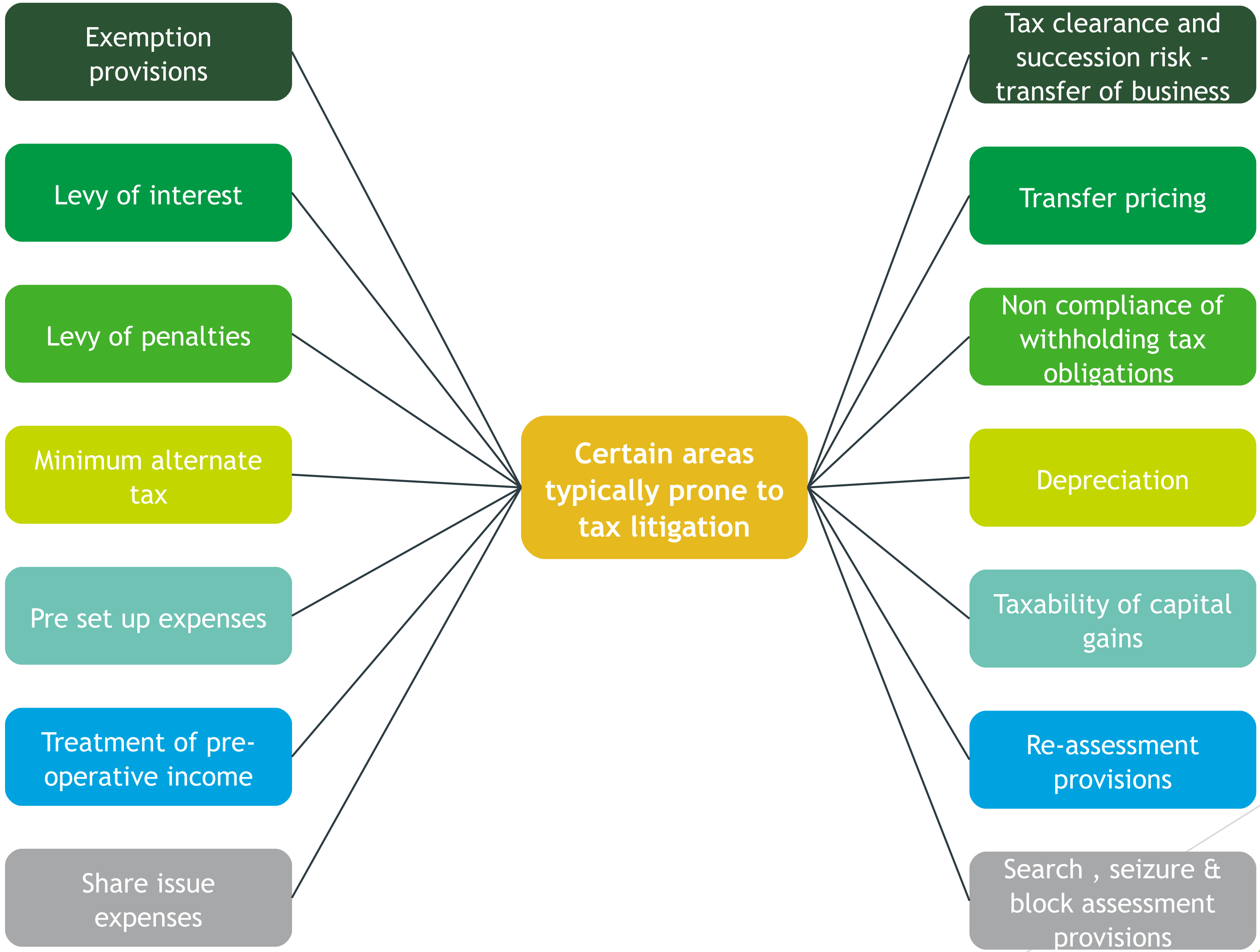
Stock Deal - Critical indicative areas for consideration - Direct tax (2/2)

Related party transactions / transfer pricing	• Documentation required to be maintained as per Transfer pricing norms • Review of assessment status for transfer pricing • Domestic transaction vis-a-vis arm's length pricing
Tax provisions and prepaid taxes	• Adequacy of provision made in the books of account • Recoverability of prepaid taxes
Deferred tax	• Deferred tax workings • Validate the tax components of deferred tax assets and liabilities
Effective tax rate	• Reconciliation of effective tax rates with the statutory tax rates • Future impact on effective tax rate
Withholding tax requirements	• Withholding tax returns filing status • Understanding withholding tax applicable on various expenses • Disclosures in the tax audit report • Payments made to non-residents • Withholding tax assessment status • Disallowance for non withholding of tax at source

Typical income-tax issues

- Disallowance of expenses incurred to earn tax exempt income
- Deemed dividend under section 2(22)(e)
- Disallowance for any provisions created for expected expenses
- Issue of shares at a premium exceeding Rule 11UA value
- Disallowance of expenses on grounds that taxes have not been deducted
- Sale of land / immovable property below stamp duty valuation
- Preliminary expenditure incurred before commencement of business
- Non-compliance in respect of to withholding tax returns
- Foreign exchange loss on capital account
- Deduction for expenses allowed only on payment basis
- Excessive / unreasonable related party payments

Other common key issues

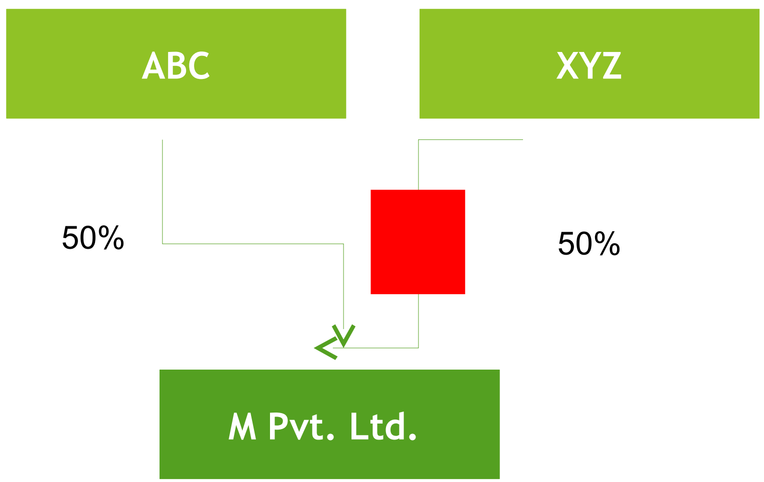


Important aspects

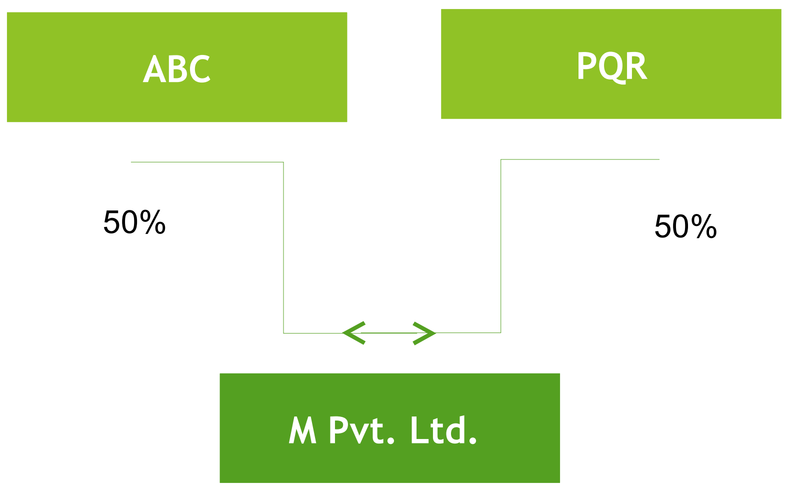
Implications under section 79

- A change in beneficial shareholding carrying voting rights in excess of 49% of a closely-held Indian company results in lapse of brought forward loss of that company

Current scenario



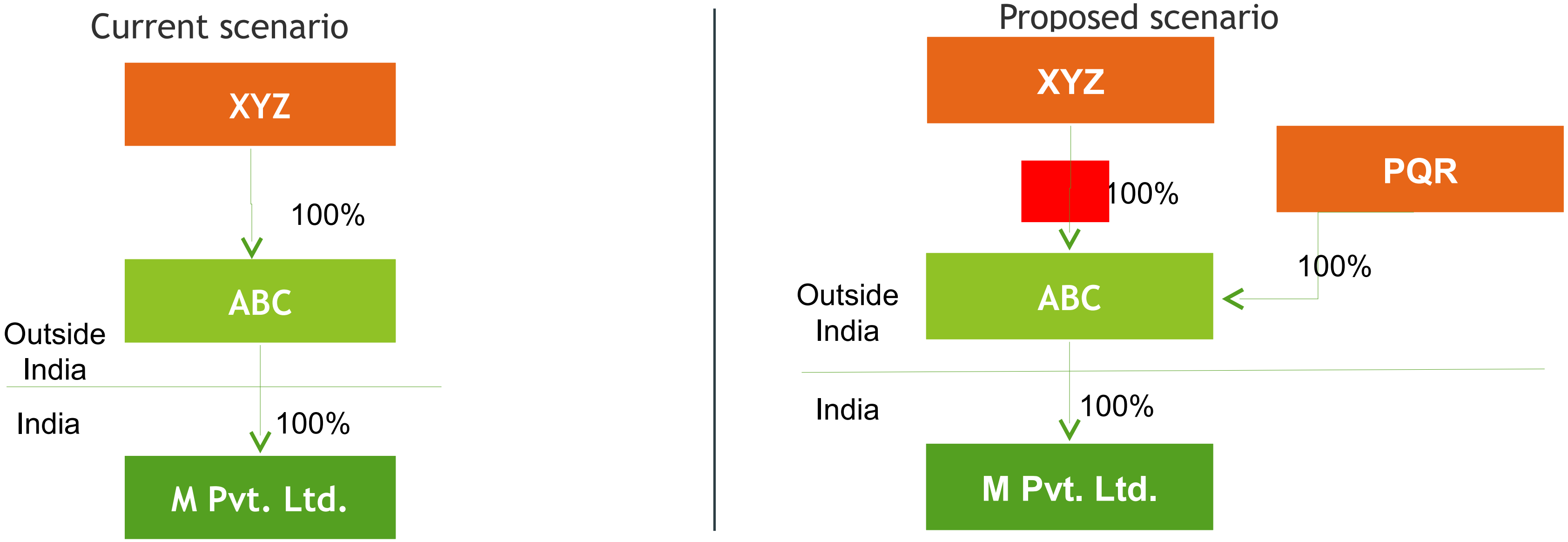
Proposed scenario



- M Pvt. Ltd. will not be entitled to carry forward & set off its business & capital loss
  - Impact on valuation to be considered
- However, ability to carry forward unabsorbed depreciation not affected

Indirect Transfer

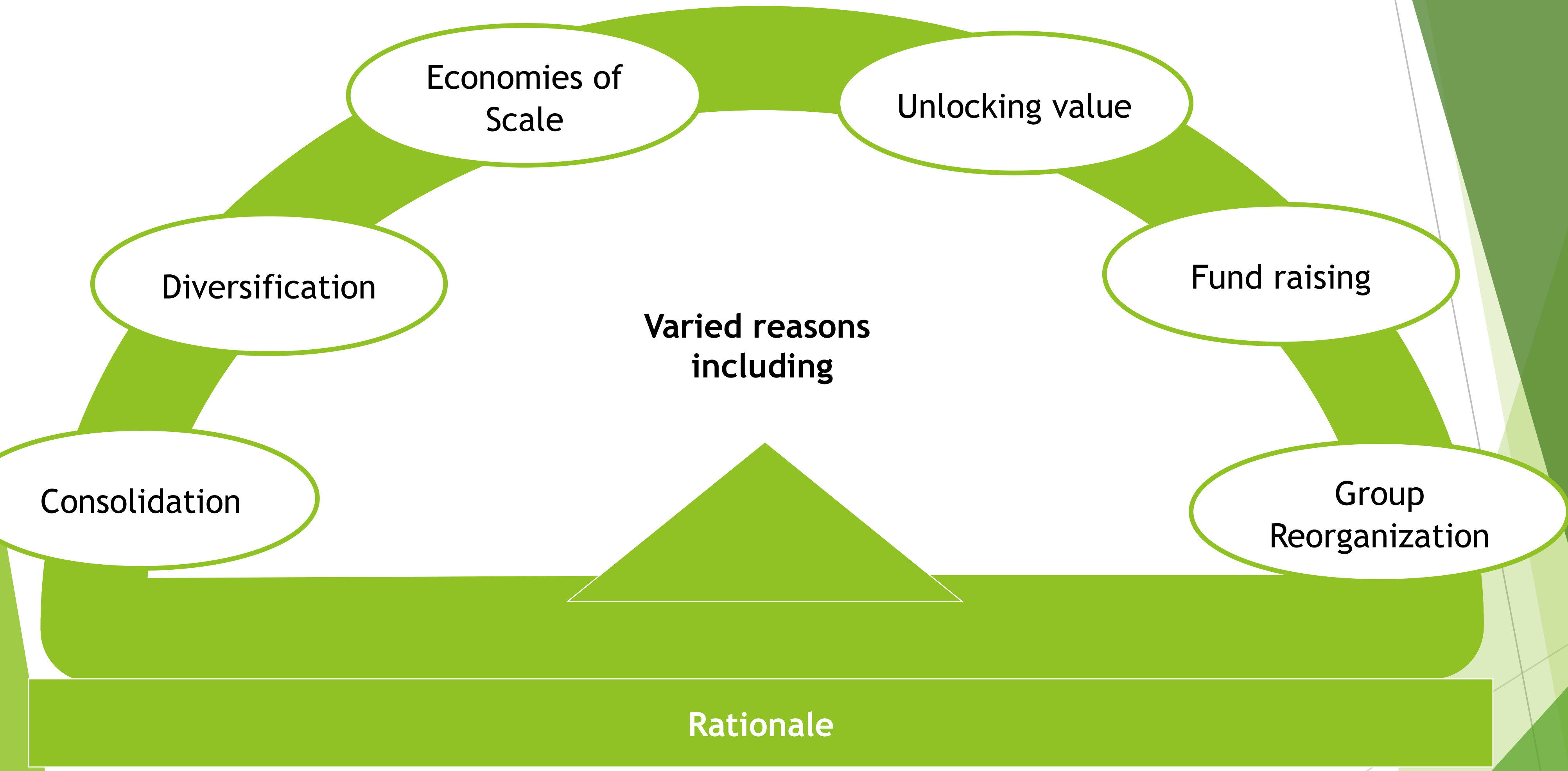
- Any share or interest in a foreign company would be deemed to be a capital asset situated in India, if such share or interest derives its value substantially, directly or indirectly, from assets located in India
- Income accruing or arising (directly or indirectly) through the transfer of such capital asset would be deemed to accrue or arise in India, resulting in a tax liability in India



Potential India tax issues in case of indirect transfer of Indian asset?

- The selling shareholder (i.e. XYZ) liable to capital gains tax in India, subject to any beneficial tax treatment provided in the applicable DTAA, if any
- Purchaser (i.e. PQR) required to withhold tax at source (equivalent to the capital gains tax liability) at the time of credit to the account of the seller or payment, whichever is earlier
- Valuation requirements and other reporting requirements to be complied with

Asset Deal - Overview



Slump sale / Demerger - Aspects

Transfer to be treated as void - Section 281

- Transfer of specified assets (such as land, building, machinery, plant, shares, securities and fixed deposit with bank) shall be void in respect of any tax payable by transferor. Transfer shall not be void if it is made:
  - for adequate consideration and without notice of the pendency of such proceedings or without notice of such tax or other sum payable by the transferor; or
  - with the previous permission of the assessing officer.
- Following are certain FAQs on section 281:

Transfer to be treated as void - Section 281

- Key highlights of the CBDT Circular 4/2011 [F. No. 402/69/2010-ITCC] dated 19 July 2011:
  - Permission to be sought in the prescribed form at least 30 days prior to the proposed date of transaction
  - Tax authorities to grant permission depending on the circumstances
  - Tax authorities are required to process the application in 10 working days
  - Permission will be valid for 180 days from the date of issue of approval / service of provisional attachment order, whichever is earlier.

Sr	Scenario	Timelines for granting permission
1	No demand outstanding and there is no likelihood of demand arising in next 6 months	Within 10 working days of receipt of application
2	Undisputed demand is outstanding and there is no likelihood of demand arising in next 6 months	Pursuant to the payment of demand along with interest due thereon by the taxpayer, within 10 working days of payment
3	Disputed demand outstanding	Once taxpayer obtains stay and indemnifies the demand, permission will be granted within 10 working days of indemnification of the demand
4	If demand is likely to arise in next 6 months	AO will consider the possibility of provisional attachment of assets (excluding the asset under consideration to protect the interest of the revenue) and grant permission within 15 working days of the receipt of the application

Section 170 – Secondary Succession Liability

- Risk of transaction / transfer being regarded as a succession
  - K H Chambers, 55 ITR 674 (SC) – 3 requisites for succession:
    - Change of ownership;
    - Integrity of business to be maintained; and
    - Identity & continuity of business is preserved
- In such a case, if the seller is not found or the tax authorities cannot recover the tax in respect of income (including gain accruing on transfer):
  - for the year preceding the year of succession; and
  - also for the period up to the date of succession (in the year of succession),
  - tax authorities can have recourse to purchaser for recovery of such demand.
- However, if tax authorities cannot recover the tax, the successor (i.e. purchaser) is entitled to recover such tax paid from the predecessor (i.e. seller) as per explicit provision to that effect.

Due Diligence findings

Discussions with other advisors on findings - Resolutions of issues identified

Documentation review

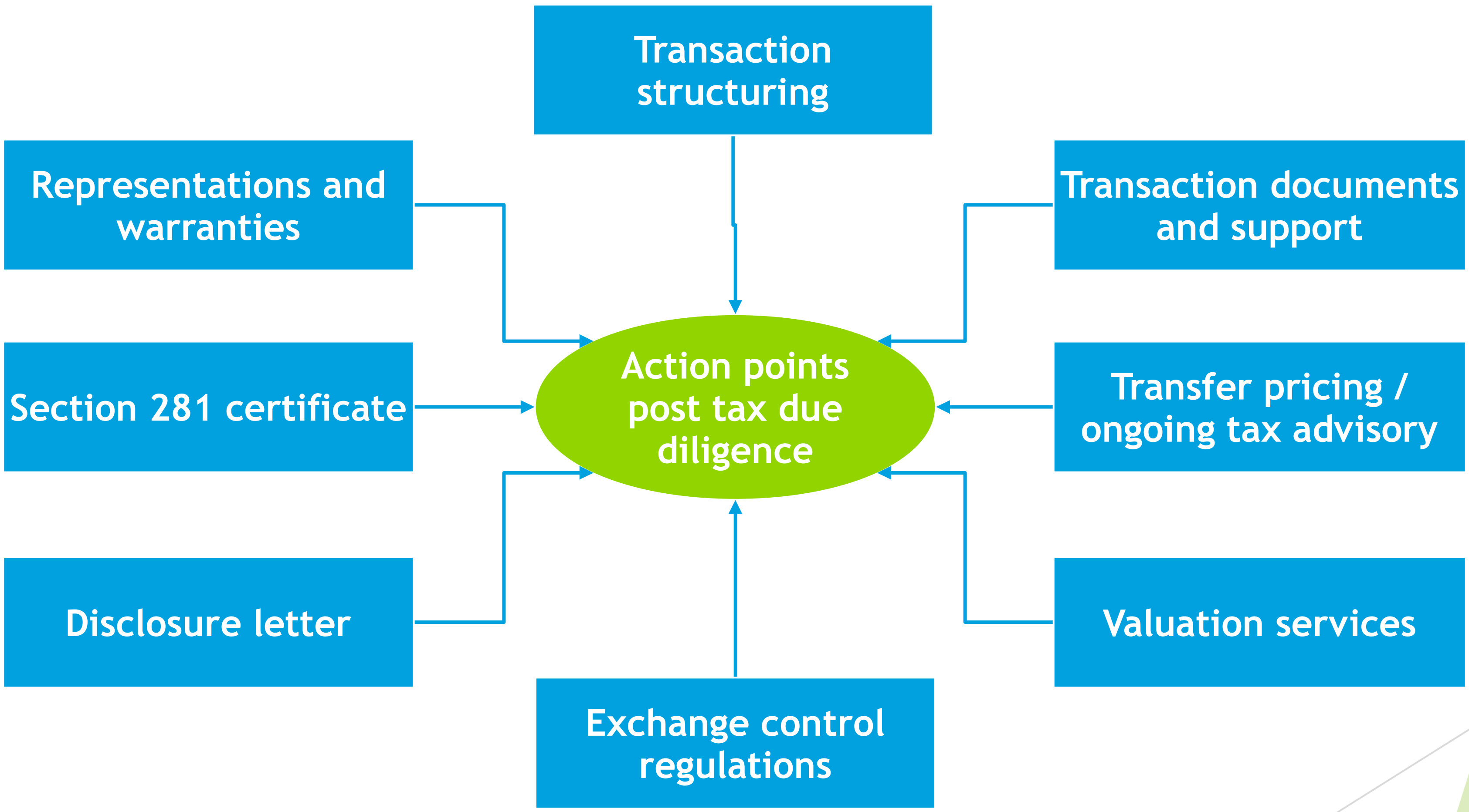
Indemnities

- Need to ensure that recommendations in due diligence report are adequately captured in transaction documents (SPA, BTA, etc.)
  - ✓ Specific Indemnity for identified tax issues
  - ✓ General indemnity for potential tax exposure for all transactions executed up to “Closing”
- Indemnity to be obtained from sellers / promoters to meet potential tax liability
  - ✓ Personal guarantee to meet potential tax liability

Representations & Warranties

- Tax warranties to be checked for adequacy & protection of interest of client
- To ensure that disclosures indicated in Disclosure Letter reflect only disclosures made during course of diligence exercise
  - ✓ Excess disclosure provides additional protection to sellers / promoters against indemnification for breach of Representations & Warranties

Post due diligence - Other aspects



Summing up


Questions?

Contact Details

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