

Deloitte Haskins & Sells LLP

Direct tax due diligence
Practical aspects

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	19,257	8,835
	17,460	70,220
	374	432
	-110	-76
	0	-830
	36,982	28,570
Term accounts	2,992	4,944
Allow and other	9,781	5,644
Notes	2,804	-11,843
Consolidation	-1,383	-322
Deferred taxes	242	761
	-4,662	-2,991
	45,854	24,662
Res	104	211
and intangible fixed assets	-13,544	-34,234
to tangible and intangible	944	112
Receivables	-14,380	-23,912
	-1,185	-1,169
	-233	0
	-1,059	-162
	-15,202	-10,522
	-17,659	-11,853
Total cash-flow	13,811	26,069
Cash and cash equivalents at the beginning of the year	15,172	166
Effects of exchange rate changes on cash and cash equivalents	228	15,132
Cash and cash equivalents at the end of the year	13,811	-11,103

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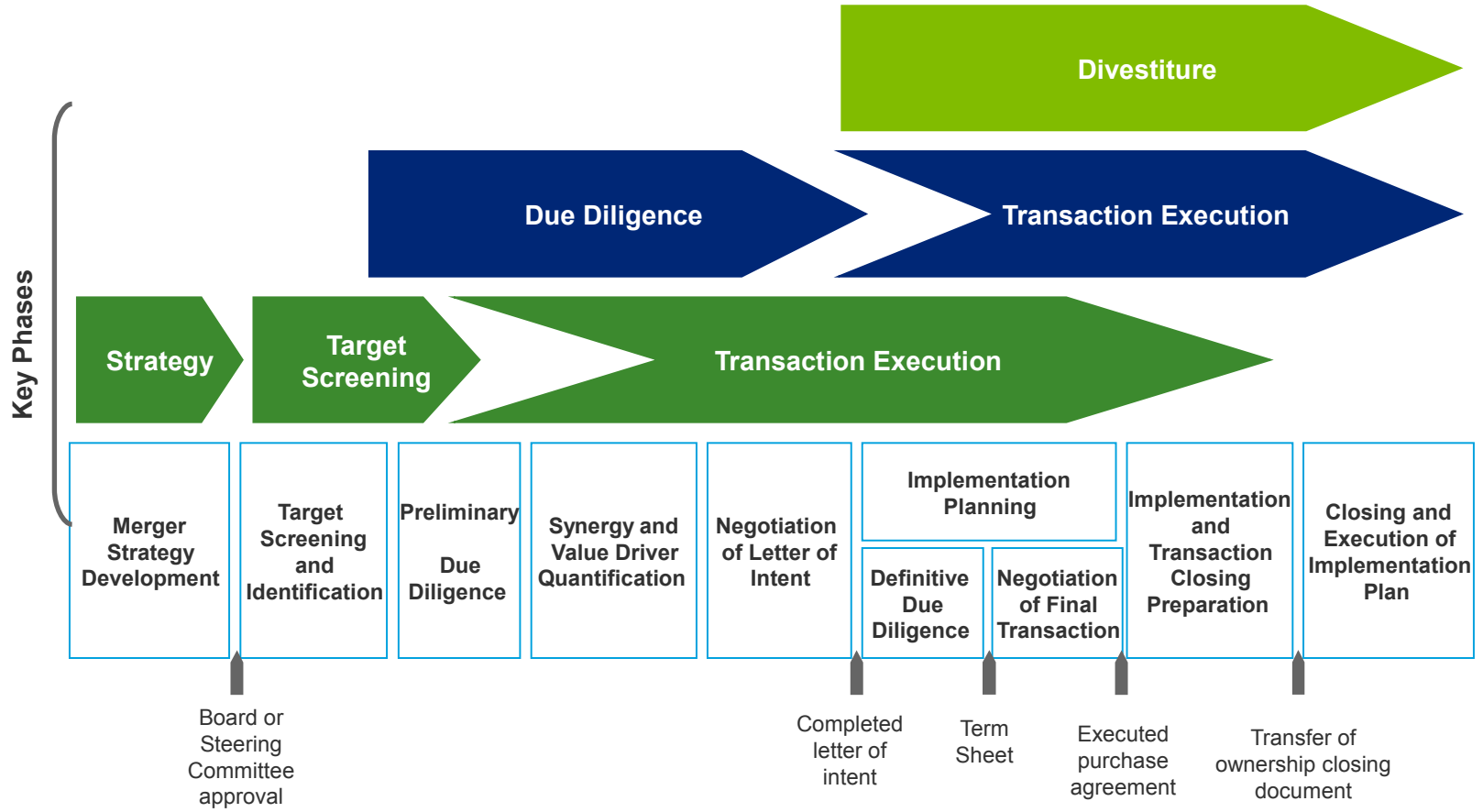


M&A lifecycle

Due diligence basics

M&A Lifecycle

- Phases



Due diligence

- What is it?

Due diligence

- Basic areas

Internal team

Commercial & operational

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.

External Experts

Types of due diligence

Scope of work

Types of deals

Stock/ Share deal

Focus is on the entire corporate set up of the Target

- Scope of due diligence is broad since all tax aspects of the Target are required to be examined

Asset deal

Focus is restricted to the carved out asset only

- Scope of direct tax due diligence is relatively limited / narrower since all direct tax aspects of the Target are not required to be examined
 - Review primarily driven by tax aspects pertaining to carved out asset only

Focus and information requirements for tax DD differ significantly

Types of due diligence

- Scope of work

Acquisition due diligence

- Done on behalf of client interested in acquiring stake in target
- Scope of work
 - Full scale due diligence
 - Limited scope due diligence
 - Desktop review

Vendor due diligence

- Due diligence done on behalf of client interested in divesting stake in target
- Scope of work
 - Limited scope due diligence

Vendor Assistance

- Scope narrower than vendor due diligence
- Restricted to presentation of facts

Framework and Objectives

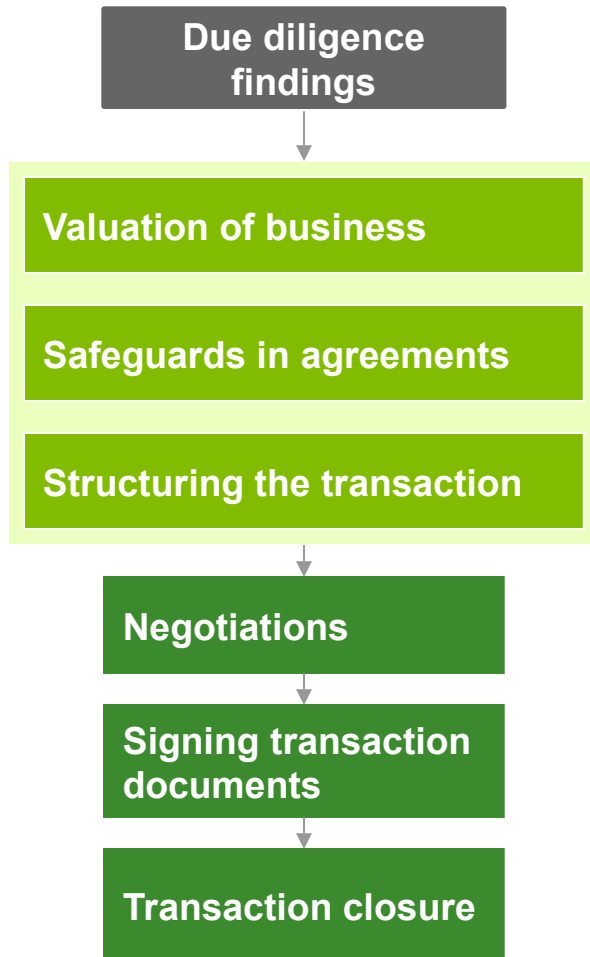
Direct tax due diligence

- Framework

Structuring the deal in a tax efficient manner (including suggestion on tax efficient structures) can be undertaken pursuant to due diligence

Due diligence

- Objectives



- 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

Direct tax due diligence

- Objectives

Direct tax due diligence

- Objectives

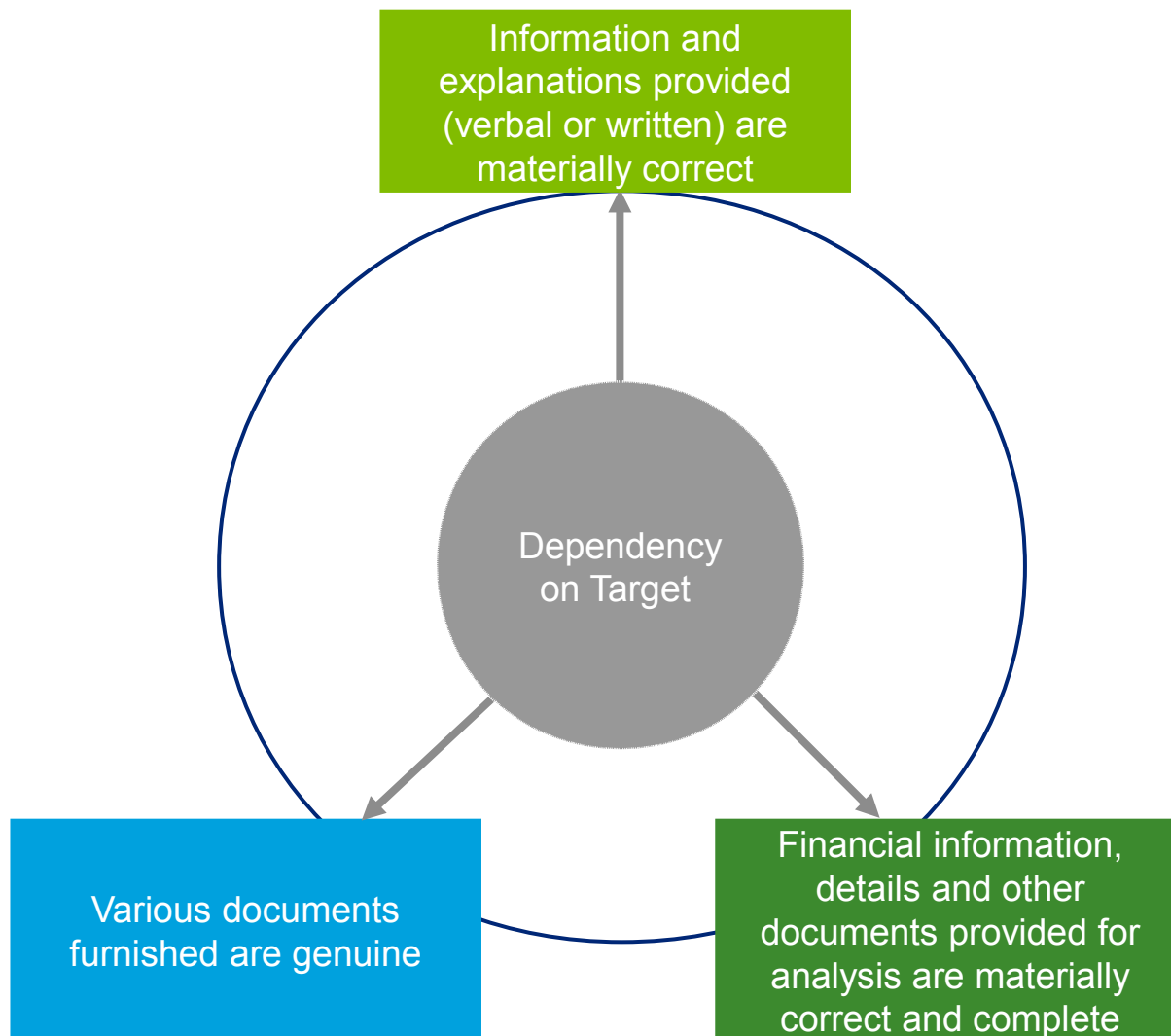
Broad process and limitations

Direct tax due diligence

- Broad process

Direct tax due diligence

- Limitations



Stock/ Share deal - Critical areas and key income tax issues

Direct tax due diligence – What we see

- Stock deal – Critical areas for consideration

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

Tax holiday / incentives

- Eligibility to claim tax incentives and 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

Direct tax due diligence – What we see

- Stock deal – Critical areas for consideration (2)

Related party transactions (including SDT)

- Documentation required to be maintained as per Transfer pricing norms
- Review of assessment status for transfer pricing
- Domestic transaction viz. a viz. arm's length pricing

Tax provisions and prepaid taxes

- Adequacy of provision in the books of account
- Recoverability of prepaid taxes
- Reconciliation of tax balances with tax returns

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

- Understanding withholding tax applicable on various expenses
- Disclosures in the tax audit report
- Foreign currency payments
- Withholding tax assessment status
- Disallowance for non withholding of tax at source

Potential income tax issues in a DD

- Disallowance under section 14A

Legal provisions

- Expenditure incurred in relation to “exempt income” is not allowable as deduction for computing taxable income
 - Exempt income includes dividends received from shares of Indian company, long term capital gain on sale of listed shares, etc.
- Amount of disallowance under section 14A is an aggregate of the following amounts (Rule 8D):
 - Expenditure directly relating to exempt income
 - Where interest expense is not directly attributable to any particular income or receipt, an amount computed in accordance with prescribed formula
 - 0.5% of the average value of investment

Impact

- Applicability of section 14A disallowance as per Rule 8D in cases of investments made

Potential income tax issues in a DD

- Deemed dividend under section 2(22)(e)

Legal provisions

- Where any payment is made by a company, by way of a loan or advance, to
 - its shareholder (holding not less than 10% of voting power); or
 - to any concern in which such shareholder is a member or partner and in which he has substantial interest (i.e. beneficially entitled to 20% or more income of such concern)

then such payment of loan or advance would be considered as deemed dividend to the extent the payer company possesses accumulated profits

Impact

- Applicability of section 2(22)(e) to be examined in respect of loans/ advance given by the Target Company to shareholders/ entities in which shareholders have a substantial interest
- Quantification of withholding tax liability along with interest and penalty in case any loans/ advance given falls within the criteria of section 2(22)(e) of the ITA

Potential income tax issues in a DD

- Issuance of shares

Legal provisions

- Finance Act 2012 has clarified that the transaction related to issuance of shares between related parties would be considered as international transaction from transfer pricing perspective
- The said transaction needs to be appropriately disclosed in Form 3CEB and the requisite TP documentation needs to be maintained
- A valuation report should be obtained from an independent valuer to prove that the transacted value per share is at arm's length
- In the absence of valuation report, the TA may attempt to re-compute the arms length price of the share using the Net asset value ('NAV') / Discounted cash flow ('DCF') method

Impact

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· If the issue price is less than the price determined by the TA, there is a

Potential income tax issues in a DD

- Corporate guarantees

Legal provisions

- Finance Act 2012 has clarified that the transaction pertaining to intra group guarantee between related parties would be considered as international transaction
- The said transaction needs to be appropriately disclosed in Form 3CEB and the requisite TP documentation needs to be maintained
- A detail benchmarking analysis needs to be conducted to determine the arm's length guarantee commission
- In the absence of benchmarking analysis, there is a possibility that the TA may proceed to determine the arm's length guarantee commission using the external CUP procured by them under section 133(6)
- The recently introduced Safe Harbour Provisions in the Act also provide that in case of intercompany guarantee transaction which does not exceed INR 100 crore, a guarantee commission at the rate of not less than 2% p.a. (1.75% in case of guarantee exceeding INR 100 crore) should be charged

Impact

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In the absence of detailed benchmarking analysis, there is a possibility that the TA may make a TP adjustment.

Potential income tax issues in a DD

- Specified Domestic Transactions

Legal provisions

- Finance Act 2012 has extended the scope of transfer pricing (TP) provisions to cover specified domestic transactions (SDT)
- Provisions apply from FY 2012–13 onwards if aggregate value of transactions exceeds INR 5 crores in relevant financial year (20 crores from FY 2015-16)
- SDT include various domestic transactions between associated enterprises in relation to income and expenses covered under tax holiday eligible units, as well as payments (expenditure) to specified related parties referred under section 40A(2)(b) of the Act

Impact

- With the application of TP provisions to SDT, pricing of such transactions will need to be determined with regard to arm's length principles, using methods prescribed under Indian TP regulations
- Accountant's report in Form No. 3CEB needs to be filed with the tax authorities
- Appropriate documentation will have to be maintained for SDT

Other key income tax issues

- Certain areas typically prone to tax litigation

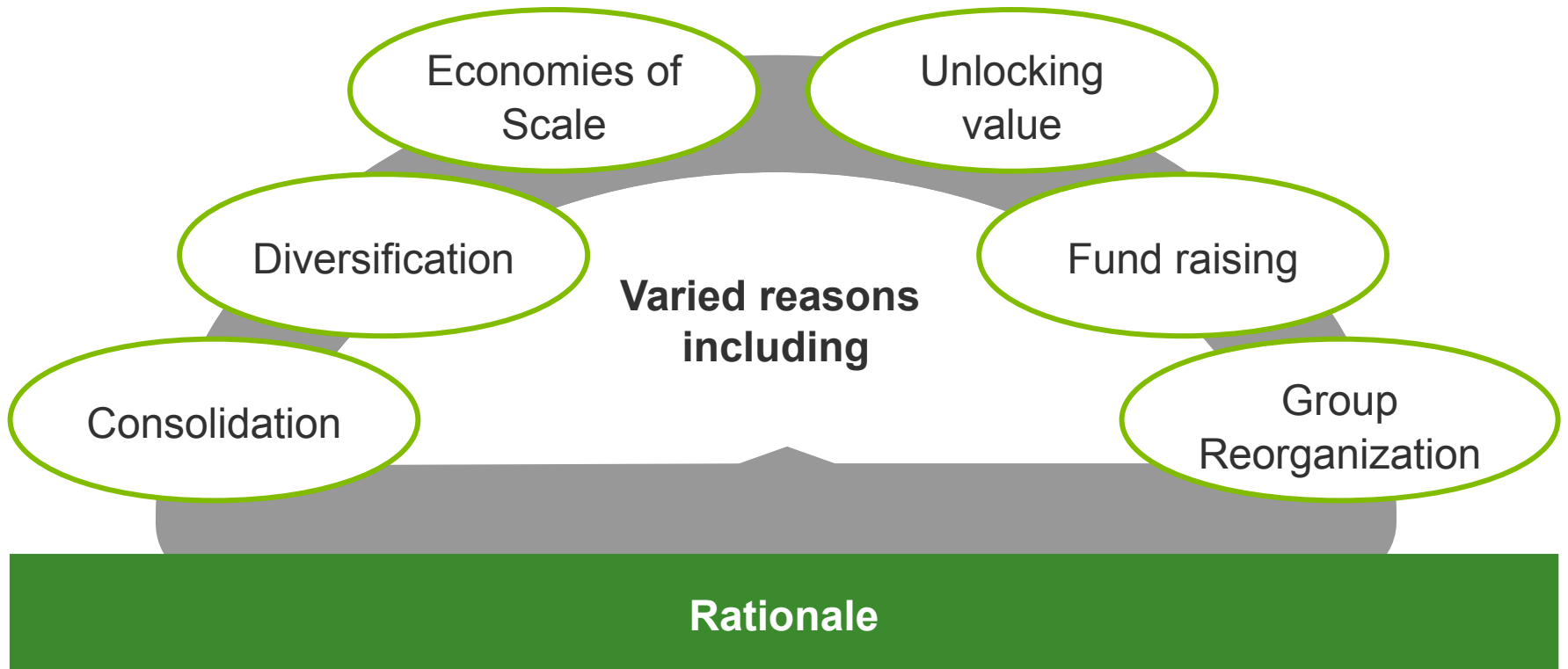
Other key income tax issues

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Asset deal - Key aspects

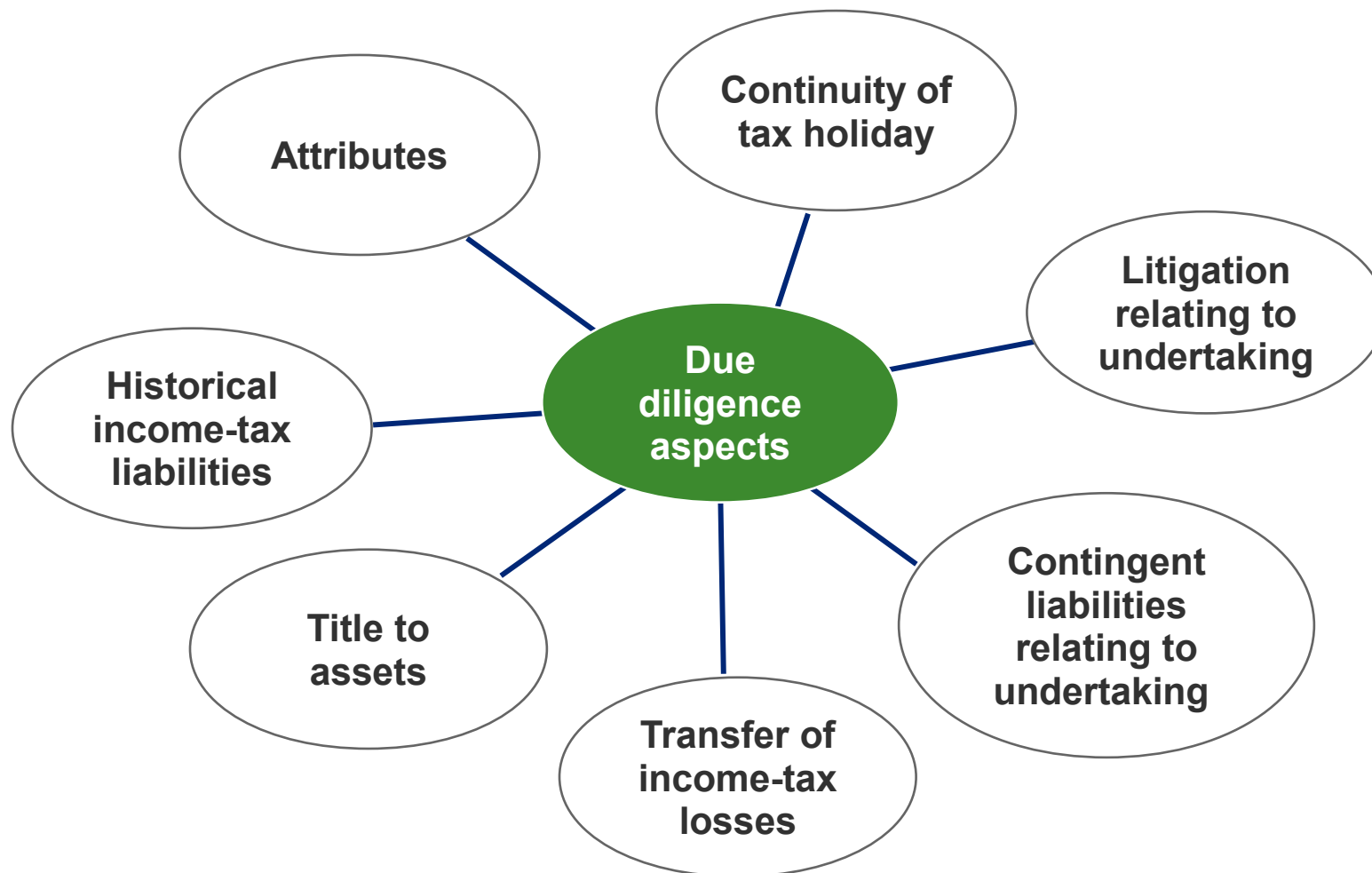
Overview

- Why asset deals?



Slump sale / Demerger

- Due diligence perspective



Potential transaction issues - Income tax

Potential transaction issues

- **Implication of section 79**
- **Legal Provision**
- 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



- **Impact**
- M Pvt. Ltd. will not be entitled to carry forward & set off its business & capital loss
 - Impact on valuation to be considered

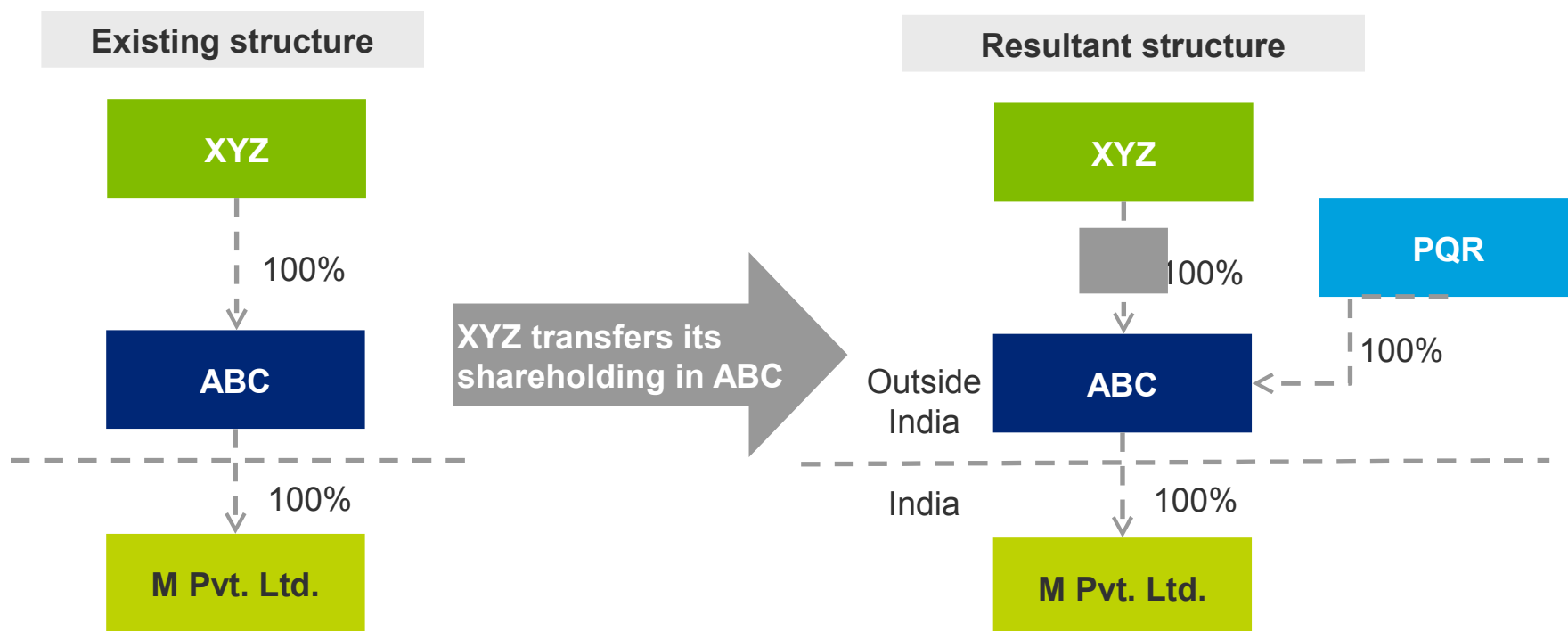
Potential transaction issues

- **Indirect transfers**
- **Legal Provision**
- 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 transaction issues

- Indirect transfers
- Diagrammatic Presentation



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

Potential transaction issues

- **Indirect transfers**
- **Potential income tax implications**
- 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



Documentation review and reporting aspects

Due diligence findings



Deal Breakers

Those issues which would impede the consummation of proposed transaction



Negotiation points

Those issues which would be necessary to consider in the valuation of business / negotiation of bid price



Issues for agreements

Those issues which would warrant indemnities and identify conditions precedent for happening of the transaction



Commercial override

Those risks and issues which are knowingly taken over as a calculated commercial decision

Due diligence report

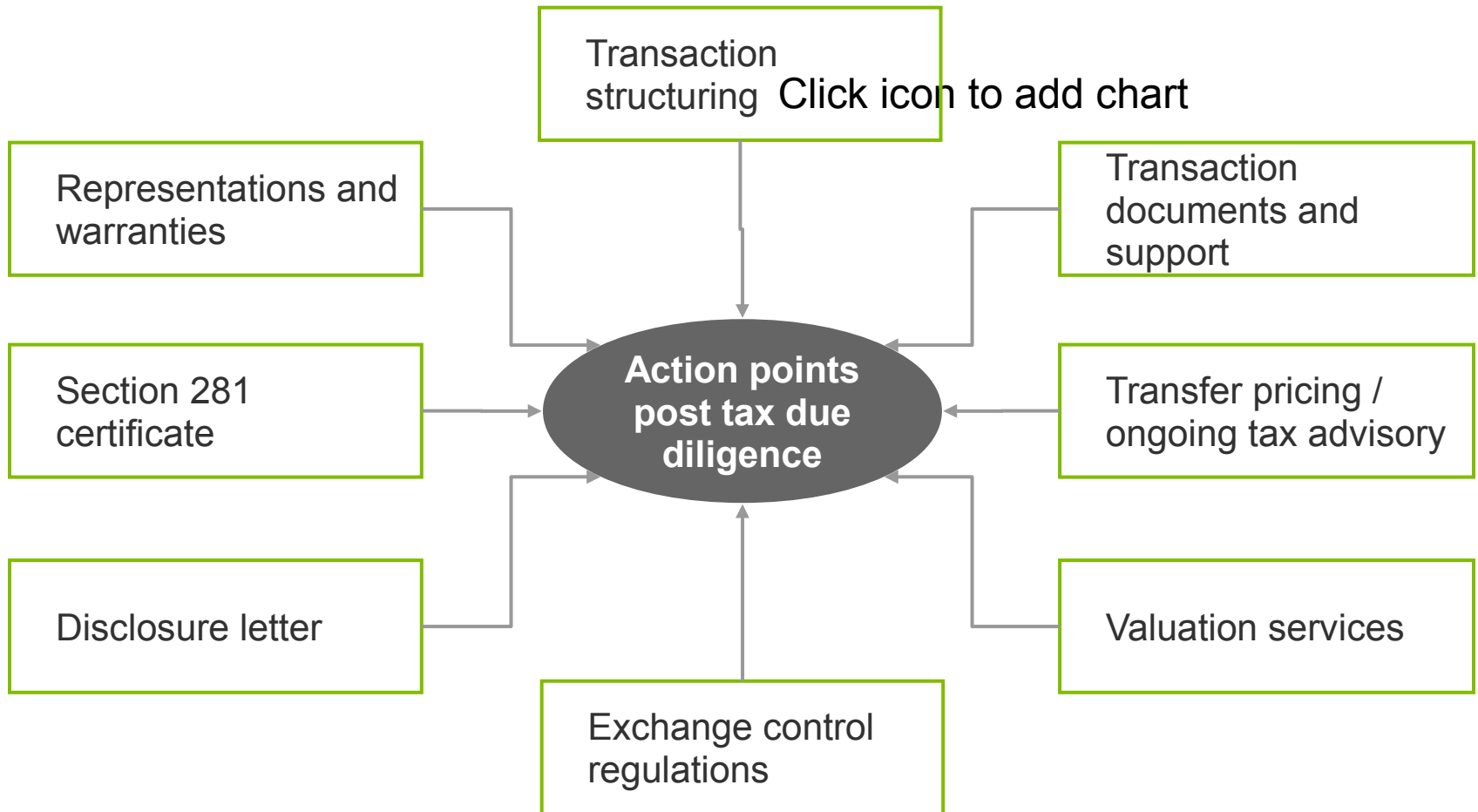
- Important aspects



Other aspects and transaction closure

Tax due diligence

- Other aspects



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
 - Insurance policy

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

Summing up

Tax due diligence

- Summing up

1 Although
2 Due
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discusses on negative information,
but rather to facilitate transactio
important role in identifying, quantifi
revels the solutions and reduce o
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