

Introduction to Tax Due Diligence

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Framework and Objectives

Global snapshot of M&A Activity

Although due diligence focuses on negative information, the aim is not to raise obstacles to transactions, but rather to facilitate transactions by identifying problems and risks and by devising solutions to problems or devices to reduce or manage the risks involved in corporate acquisitions.



Due Diligence plays an important role in identifying, quantifying and reducing the risks of an acquisition.



Typical methods of investment

The methodology of the DD will depend on the method of investment. Generally, DDs are not conducted when it's a business carve out/ asset purchase.



Stock/Share
Purchase

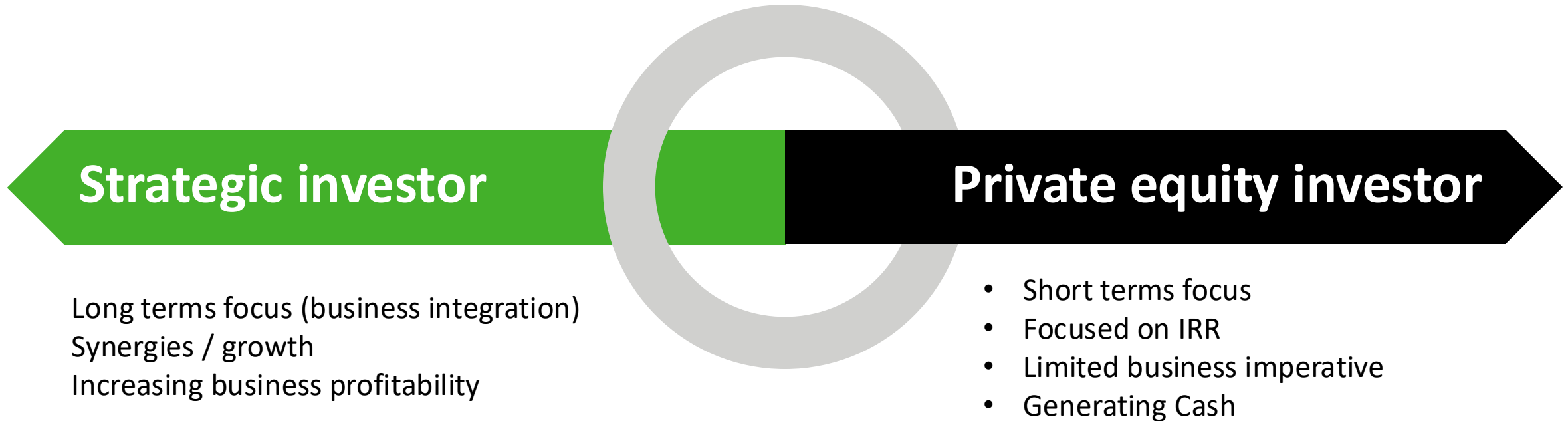


Carve out
of business



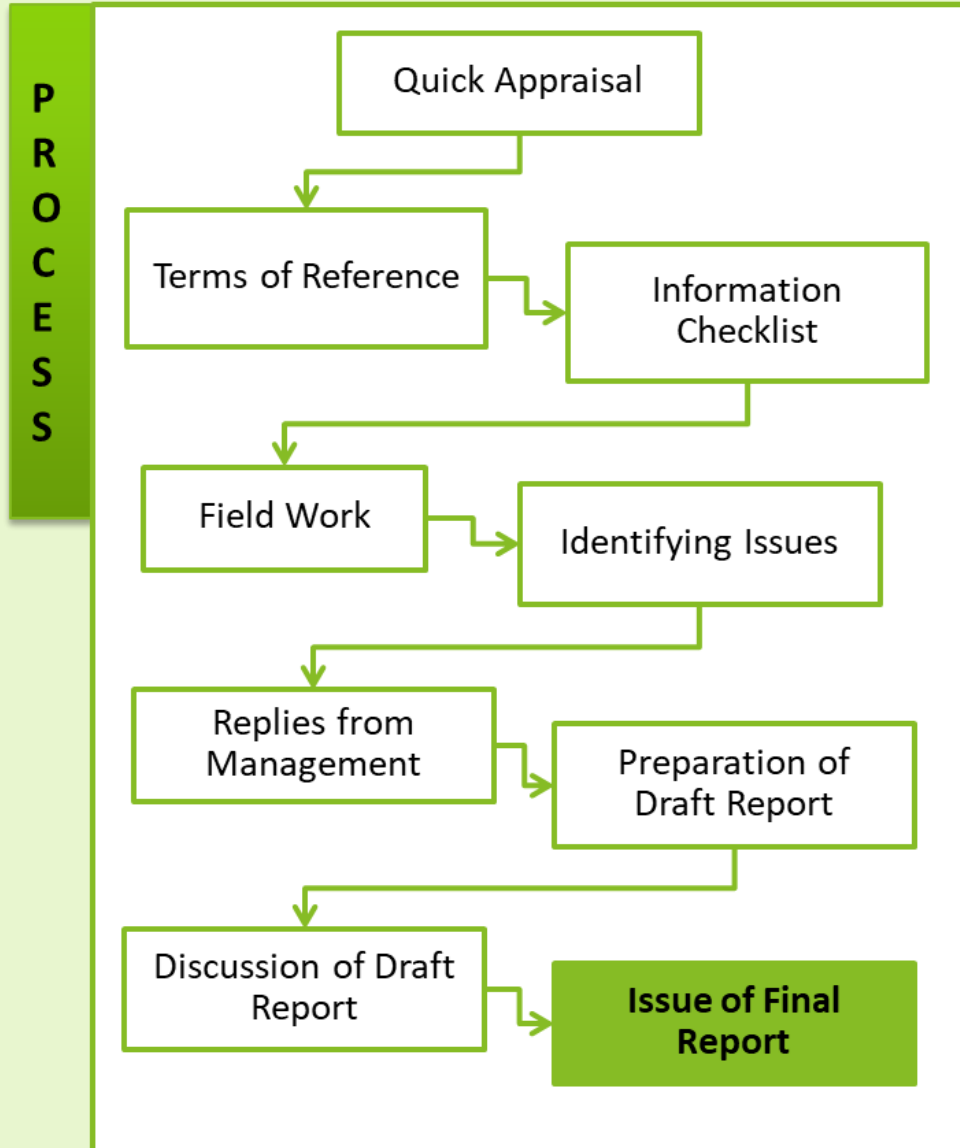
Amalgamations

Typical investors



Approach

“The steps involve an interface with the management and other advisors to ensure that all aspect of the project are duly considered and reviewed. This is a pre-requisite for a well-informed decision.”



Tax due diligence

Understanding the target

Identifying the data required

Assessment of tax impact arising from “change in control”

Assessment of historical tax exposures

Assessment of current tax position

Assessment of various modes of tax neutral deal structuring

Identifying tax saving opportunities

Key Areas

Understand the transaction and its context

- Purpose of transaction
- Tax structure

Review historical tax compliance

- Tax filings
- Tax returns and audits
- Outstanding liabilities

Assess tax positions and risks

- Tax positions
- Tax losses and credits
- Transfer pricing

Key Areas

Identify key tax risks

- Uncertain tax positions/ controversial interpretations
- Cross-border issues
- Tax compliance/ historical tax issues look for any prior investigations or issues related to tax *fraud, tax evasion, or non-compliance*
- Contingent liabilities

Evaluate contractual and legal risks

- Tax covenants in existing contracts
- Tax liabilities from litigation

Review tax compliance and controls

- Internal controls
- Tax risk management

Key Areas

Document the findings and report

- Risk assessment matrix
- Recommendations
- Due diligence report

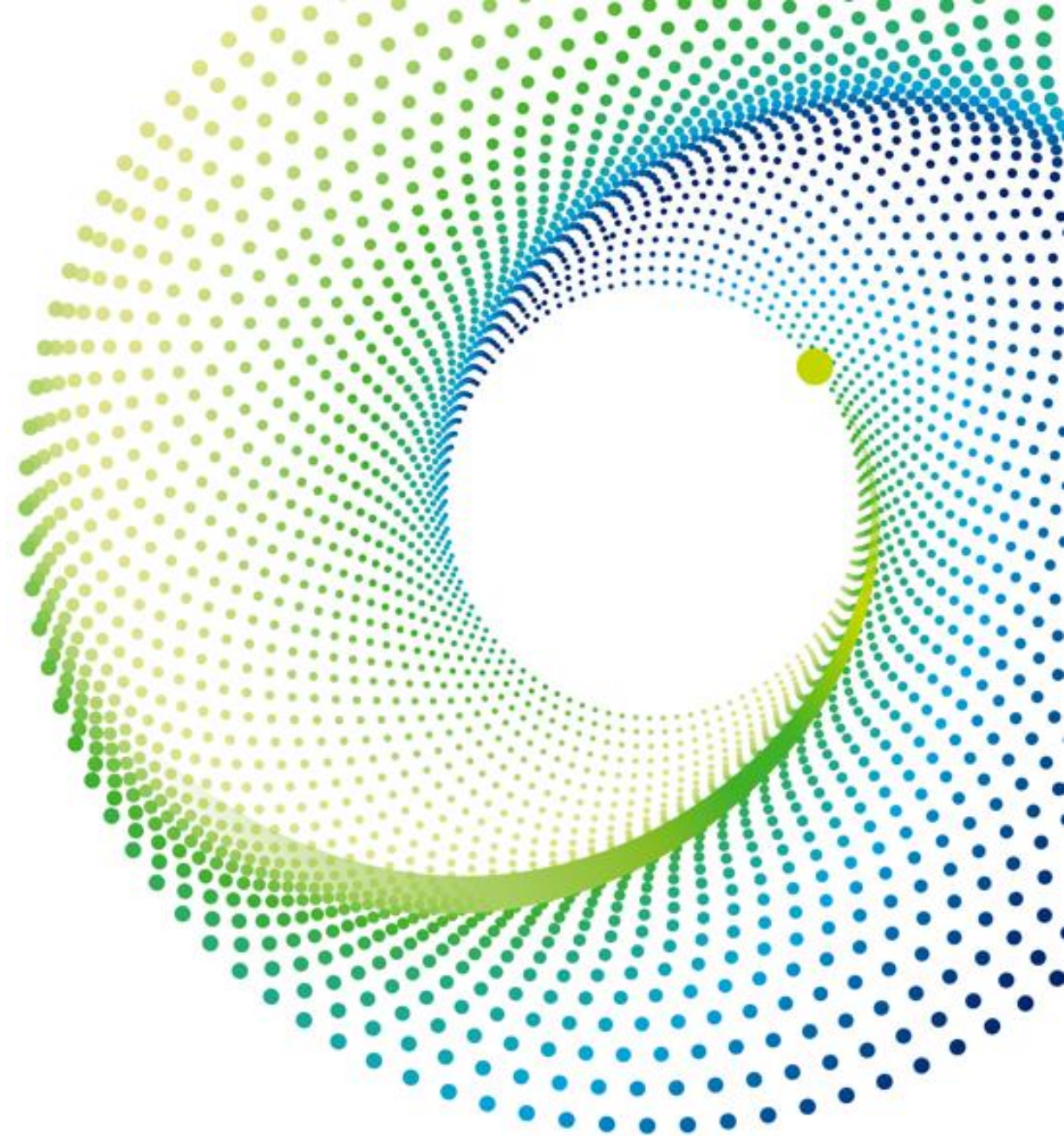
Tax structuring

- Transaction structure
- Mitigation strategies

Post-transaction monitoring

- Ongoing compliance
- Integration issues

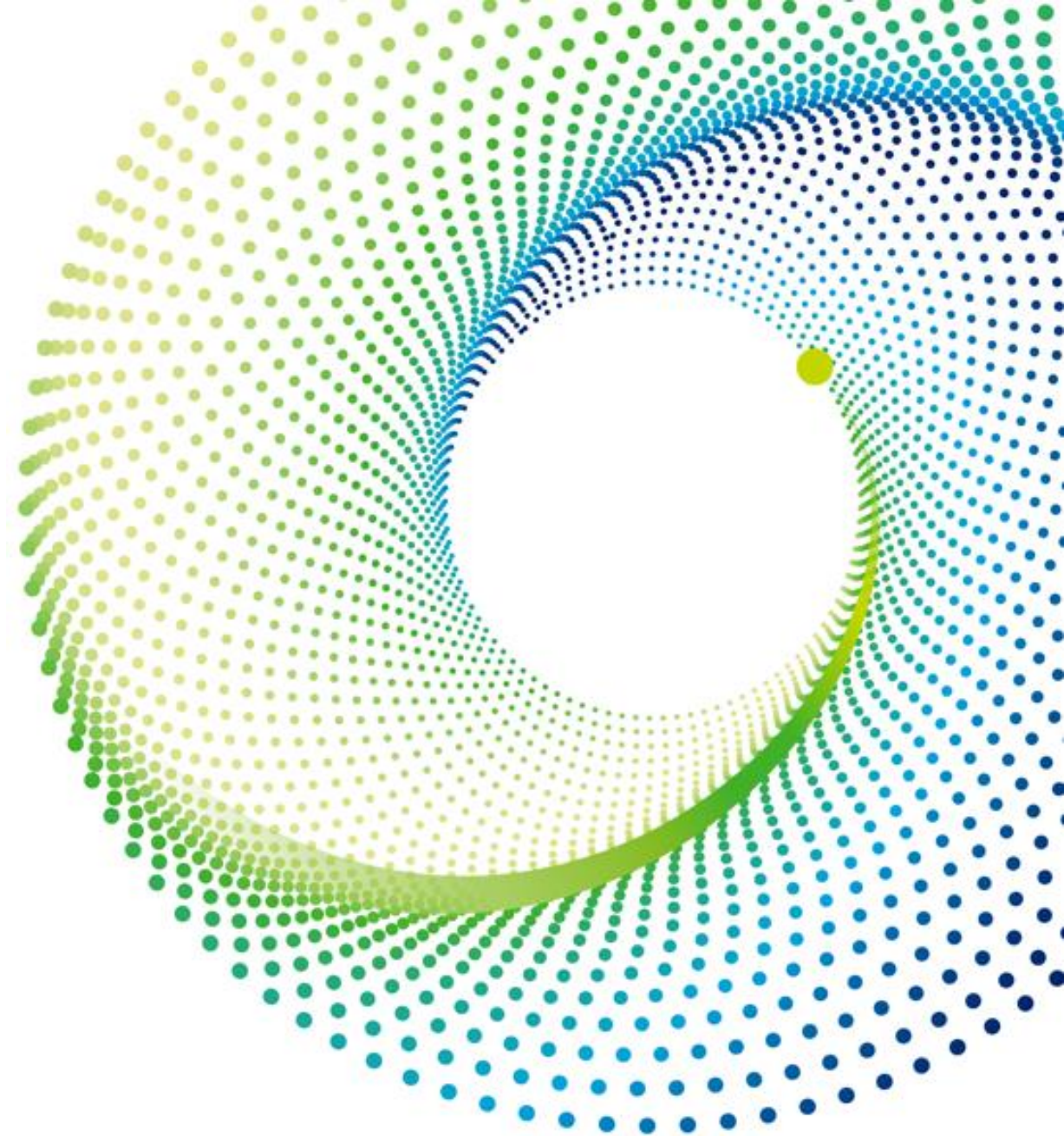
Reviewing Corporate Income Tax Returns and Financial Statements



Typical Issues



How to Carryout a Tax Due Diligence on a Corporate Income Tax Return



Examine the tax return

- Open years (time bar is 30 months)

Cross-check financial statements

- Segmental analysis for exempt or concessionary rates

Identify adjustments & reconciliations

- IT vs indirect taxes, provisions etc.

Verify income sources and deductions

- Liable / exempt revenue sources, applicable rates
- Expenses and deductions: *sample check on related party transactions, CBA and allocation of expenses*
- Tax credits: *receivables in the balance sheet vs tax return*
- Tax holidays: conditions, BOI certificates, SDP Gazettes

Check for potential tax liabilities and compliance risks

- Tax positions & disputes: *outstanding tax assessment statement*
- Open years & audits - Compute potential additional tax liabilities for open years
- Transfer pricing

Evaluate Loss Carryforwards and Carrybacks – loss set off rules, reconcile with DT Asset

Examine Tax Payments: Due dates, Period codes etc.

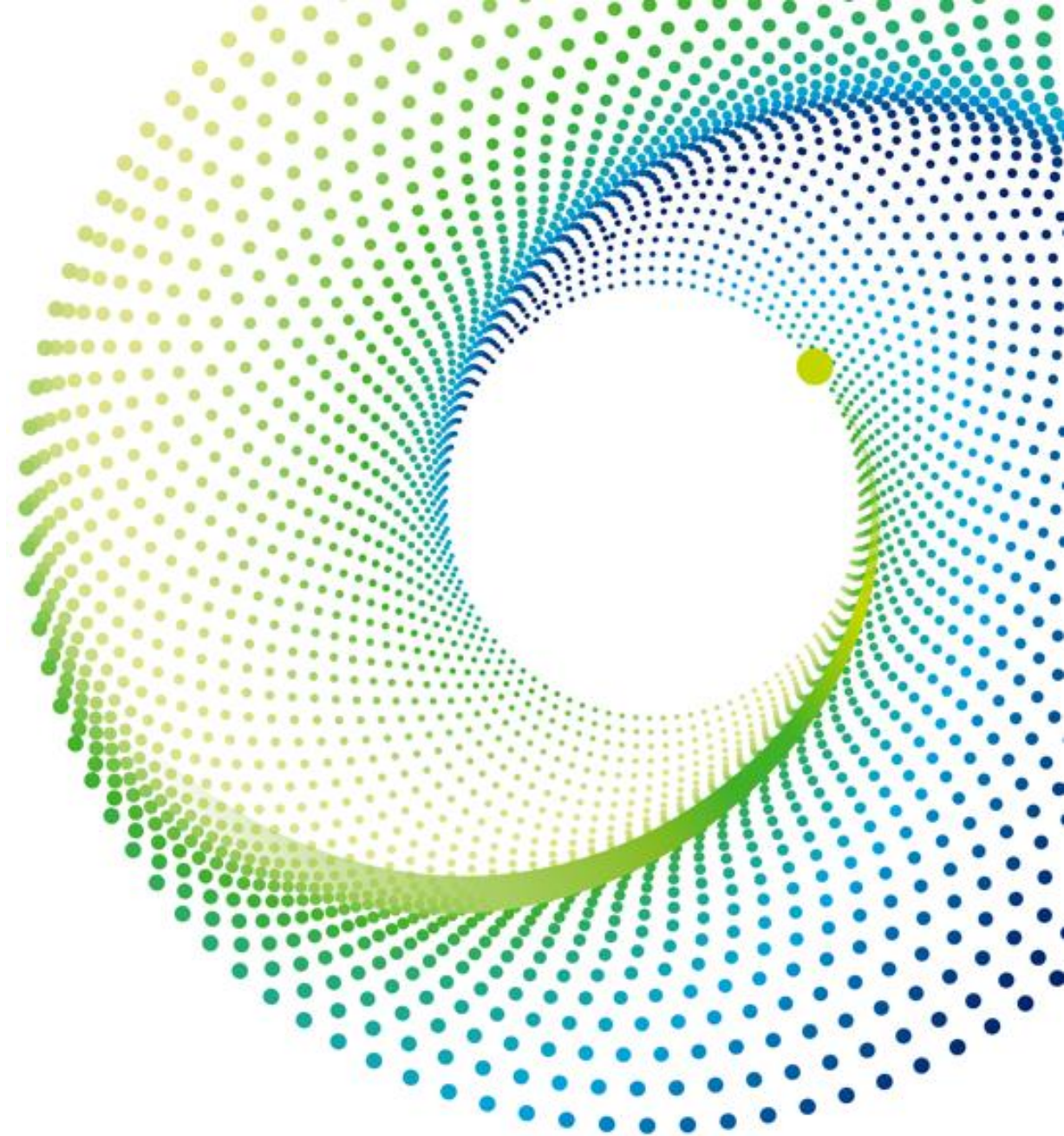
Review other credits: WHT/ AIT/ FTC Certificates and Proof for qualifying payments

Return filing compliance: date of filing, supporting documentation

Compute cost of non – compliance

Tax Planning Opportunities

Employee-related Taxes: Payroll Tax Compliance and Obligations



Review APIT returns and cross reference with "personnel cost" declared in financial statements

Highlight discrepancies and perform reconciliations

Review all staff welfare benefits

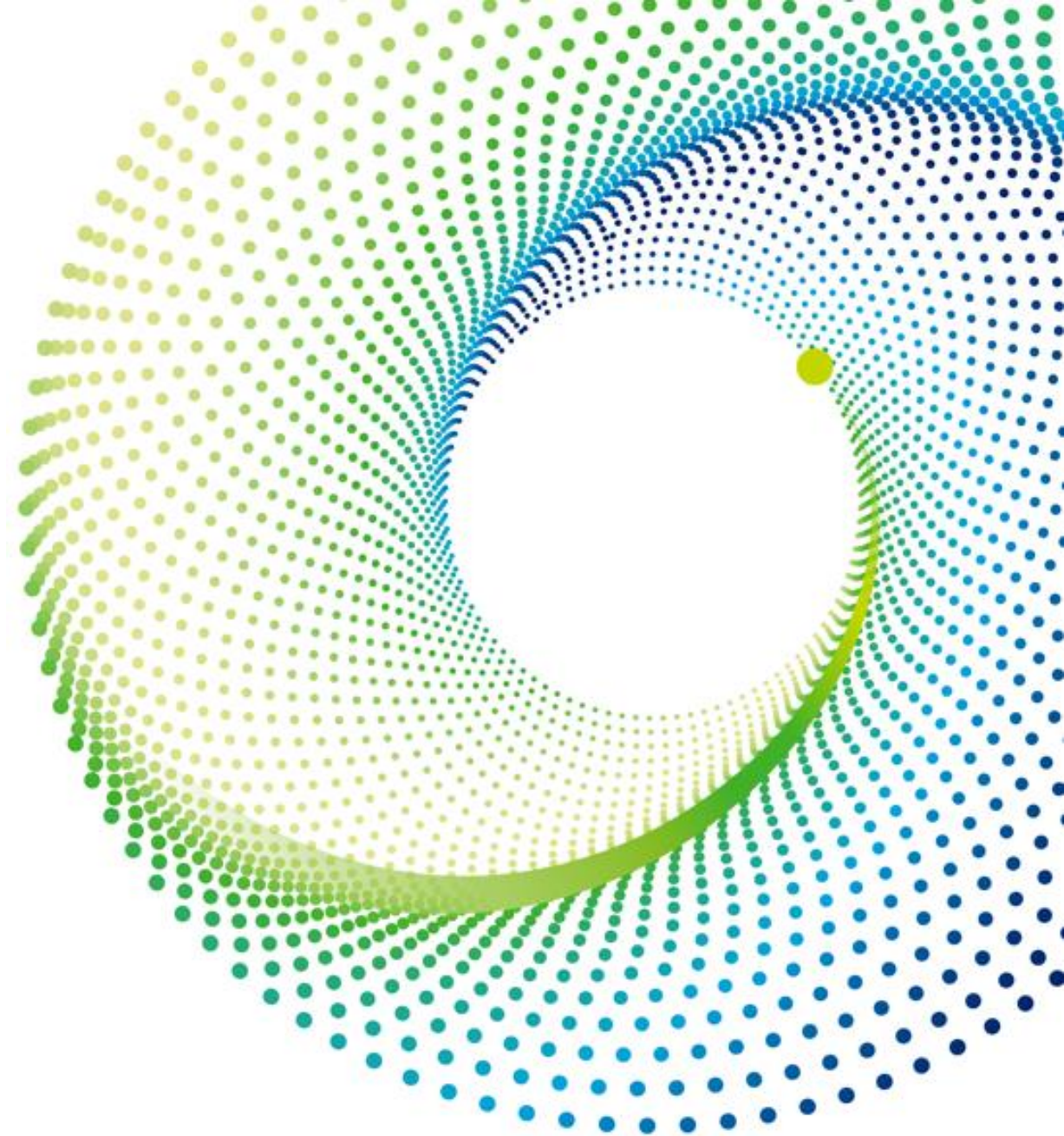
Sample verification of APIT calculation - *obtain cash vs non-cash benefits of each grade*

Compute cost of non-compliance: exposure to penalties and interest

Examine APIT return filing and payment compliance and verify against remittance slips

Review EPF, ETF and Gratuity calculations and identify any outstandings

How to Carry out a Tax Due Diligence on a Value Added Tax Return



VAT returns VS corporate income tax returns VS financial statements reconciliations

Assess nature of supplies –
exempt, liable, zero rated, out of scope

Verify accuracy of input tax credits against VAT returns and financial statements, disallowed input

SVAT credit vouchers

Payment & Return compliance

Computuing potential exposure, cost of non – compliance

Other Indirect Taxes



**Customs >
Outstanding
taxes**



**Stamp Duty >
Specified
instruments**



**SSCL > Assess
nature of
turnover and
reconcile return
against FS**

Change in control [s.64 of the IRA 2017]

Rules to prevent persons from buying entities for the purposes of securing tax benefits

- **If underlying ownership** of an entity (i.e. membership interests in a **company, partnership or trust**, owned directly or indirectly through one or more interposed entities, by individuals or by entities in which no person has a membership interest) **changes by more than 50%** as **compared** with that ownership at any time during the **previous 3 years** and
- **If**, In the case of a **company or partnership**, such company or partnership **does not conduct the same business** after a change as it conducted before the change **for a period of 2 years after the change (i.e. if the business continuity test is not met)**

The **following tax benefits are not permitted** for such an entity **after such change of ownership**

Tax Benefit	Permissability
Disallowed finance cost (incurred prior to the change) which is carried forward	Not permitted to be deducted after the change
An unrelieved loss (incurred prior to the change)	Not permitted to be deducted after the change
An amount included in calculating income (prior to the change)	Not permitted to be deducted if such amount is refunded/disclaimed or written off after the change
In the case of a long-term contract, a loss incurred after the change	Not permitted to be carried back to a Y/A before the change

Understand the Transaction – Carve out



Tax liabilities are attached to the entity



Historical tax events irrelevant

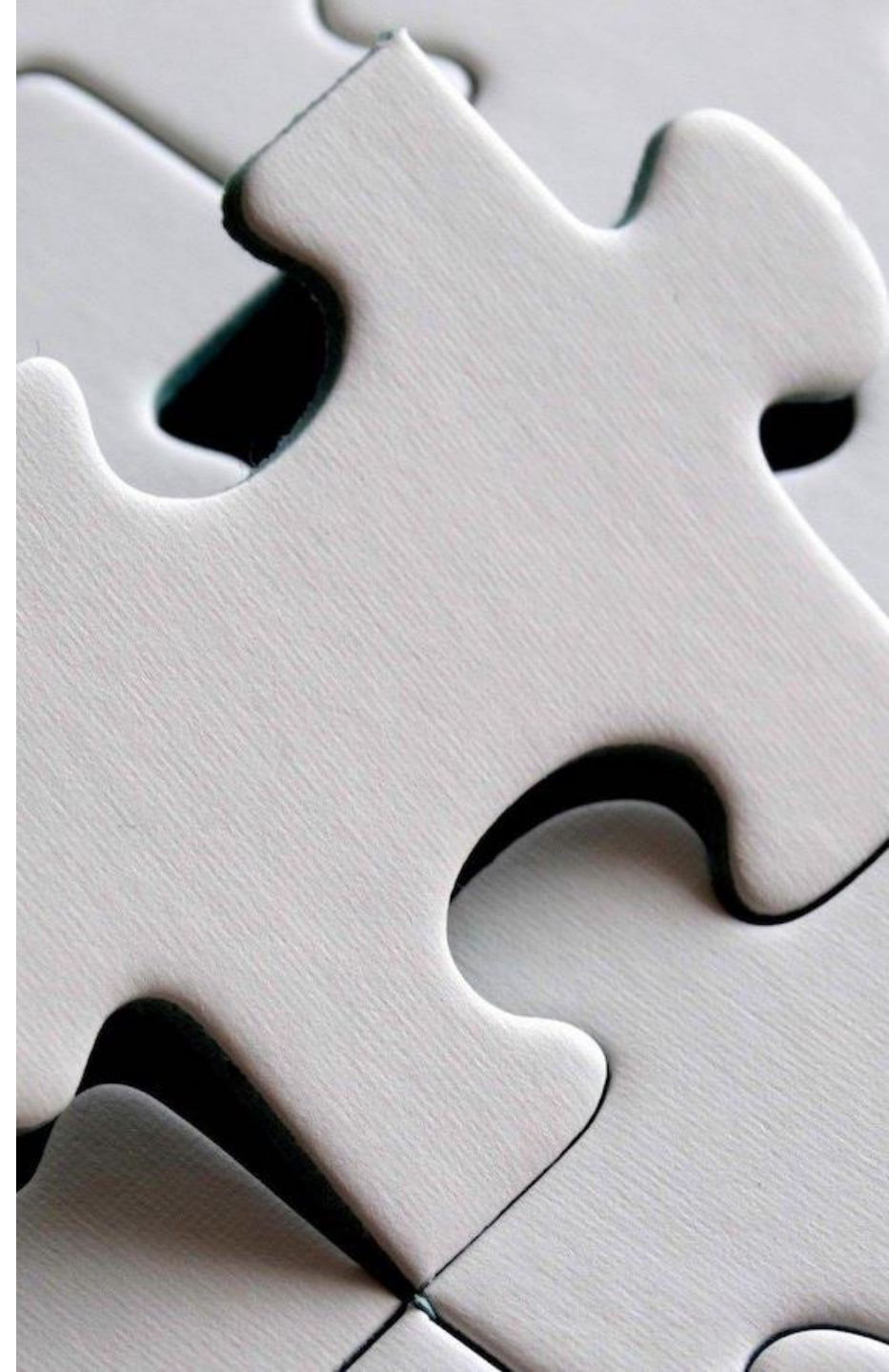


Transactional taxes

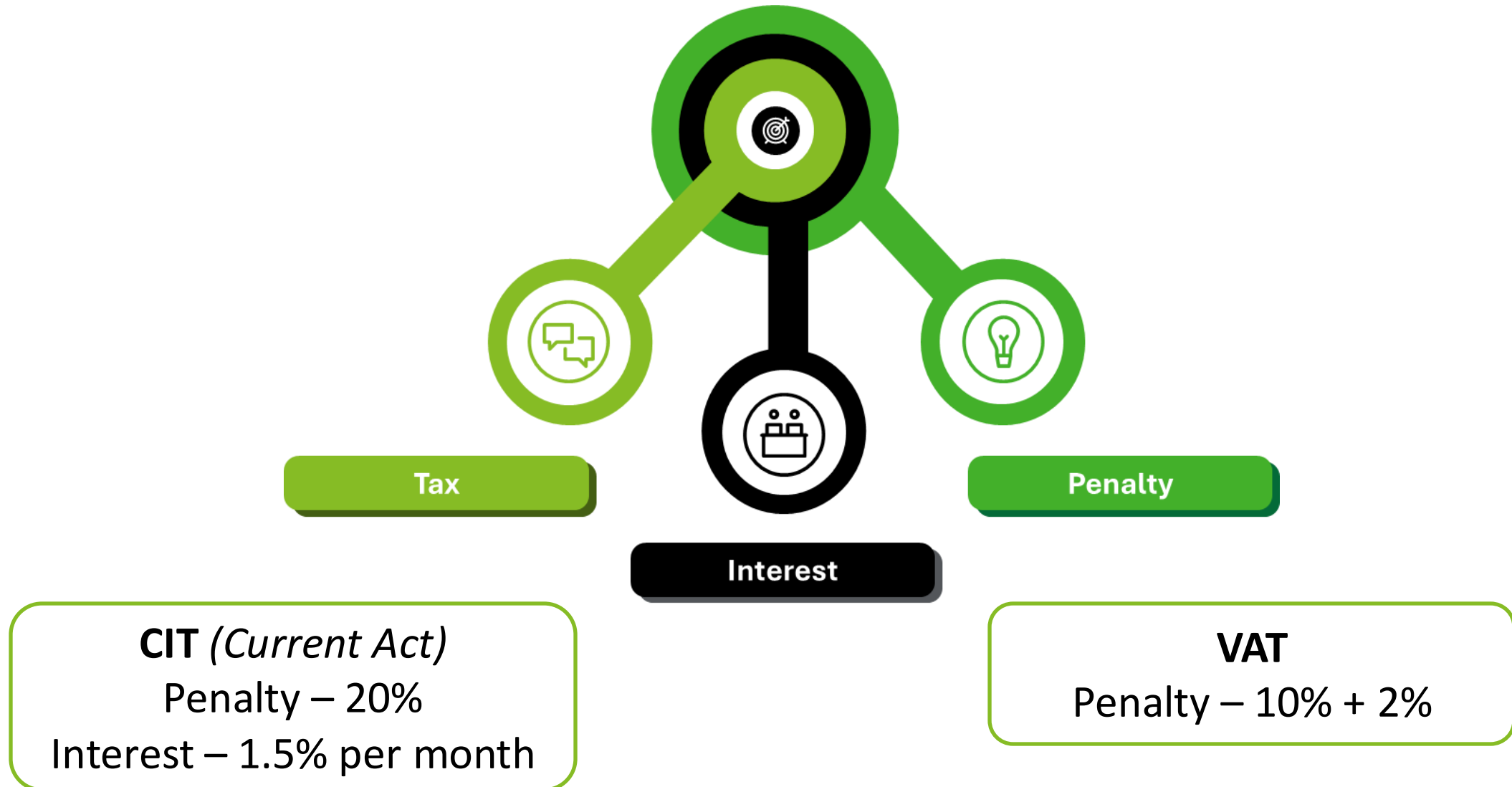
- VAT – supply of a service – application of 16(5)
- SSCL, Stamp Duty
- Income taxes on disposal on transferor
- Value of assets

Understand the Transaction - Amalgamation

- No specific provisions
- Sec 239 to 245 of the CA sets out the provision relating to amalgamation of companies
- Losses, tax credits & refunds
- Stamp Duty on property
- Special concessions of amalgamating entity e.g. BOI
- Bargain purchase and resulting unrealised gains
- Realisation of assets – Sec 46(5) of the IRA
- Write-off of bad loan - Deductibility
- VAT on transfer – 16(5)



Crystallization & quantification



Avenues of recourse to buyer & SPA



Price
Adjustments



Escrow
Agreements



Tax Adjustments
Or Claims



Warranties



Indemnities



Termination
Rights



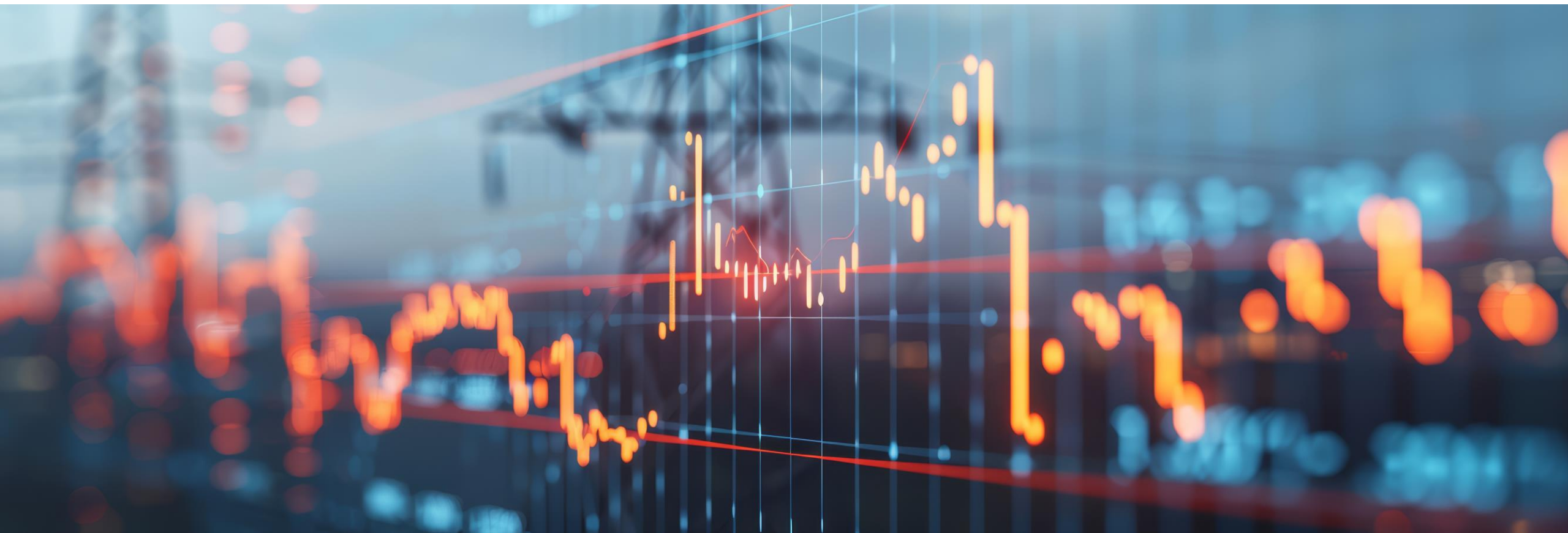
Tax Covenants &
Agreements



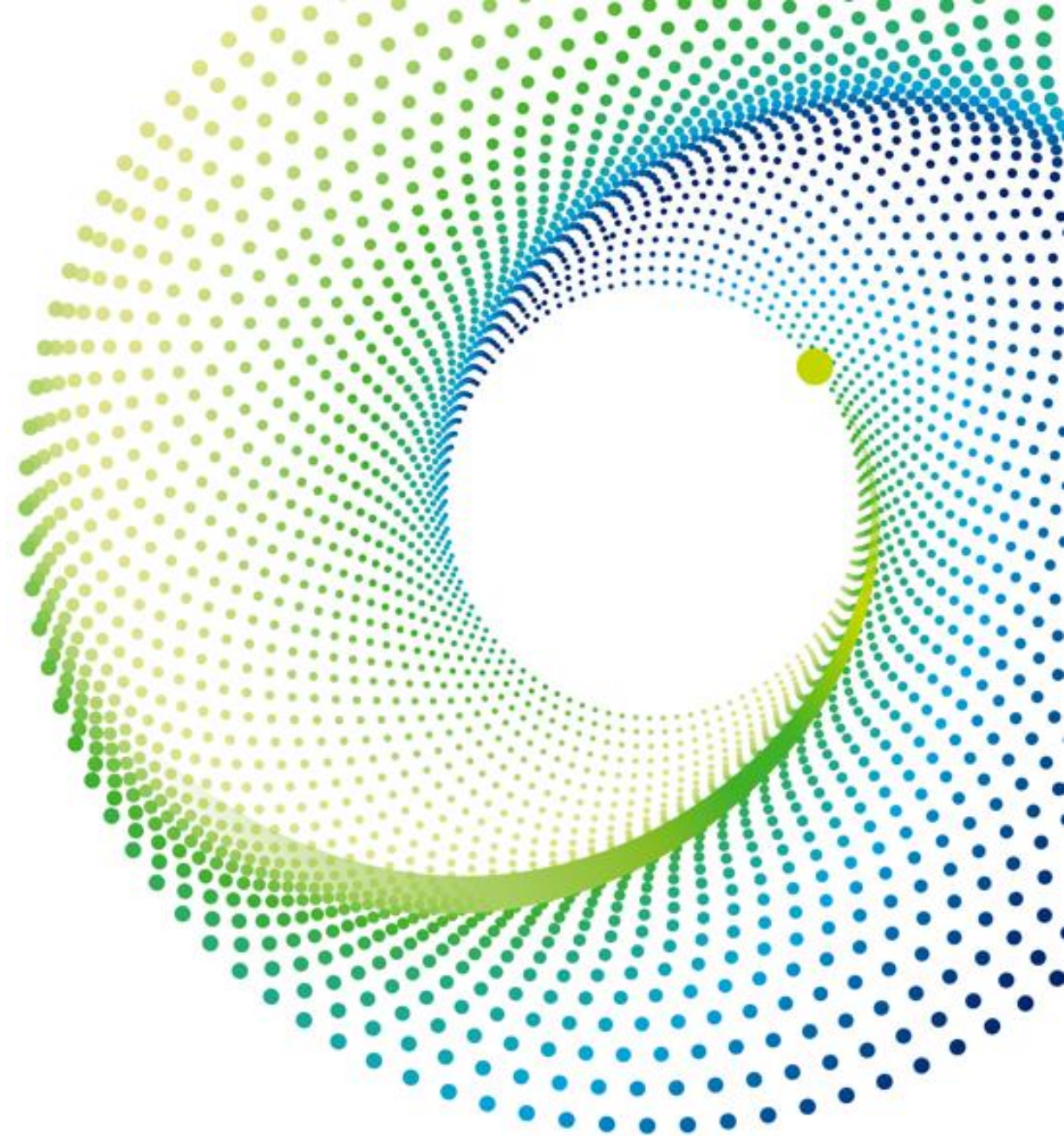
Insurance/
underwriting

Purchase Price Adjustments

If the TDD uncovers liabilities or risks that were not anticipated, the buyer may negotiate a reduction in the purchase price to reflect the discovered tax issues. This is often done as part of the transaction's final purchase agreement.



Share Purchase Agreements (SPA)



Escrow Agreements

An escrow agreement may be used to set aside a portion of the purchase price in an account that is held by a third party (typically an escrow agent). This money can be **released to the seller after a specified period** or used to **cover certain liabilities**, including tax issues, if they arise after closing.

Escrow can be particularly useful when tax liabilities are uncertain or contingent (e.g., pending audits or disputes) and the buyer wants to protect themselves against potential exposure.



Tax Adjustments/Claims

The buyer can request that the seller resolve or settle any tax claims or issues identified during TDD before the closing. This could involve the seller paying any outstanding tax liabilities or addressing specific issues.

If the issue is not resolved pre-closing, the buyer may seek to include provisions that allow them to assert claims on the seller's behalf or require the seller to assume responsibility for certain matters post-closing.



Tax Warranties

A statement of fact by the seller concerning the business being sold.

In accurate facts – buyer claims damages.

Warrantor unable to pay for any breach - the warranties do not offer the buyer any protection.

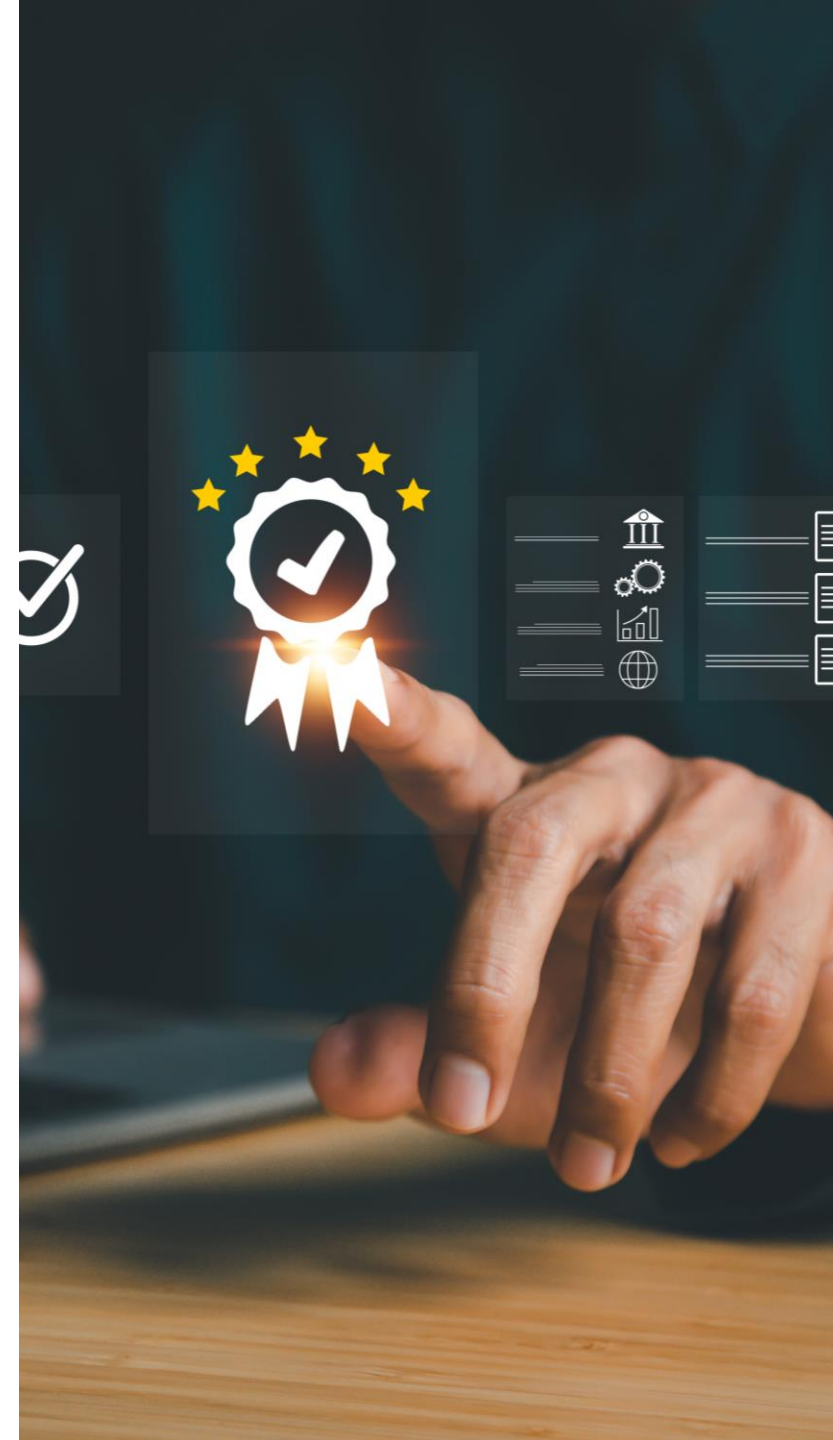
Practically recovering damages under warranty requires litigation – less effective than an indemnity.



Warranties are not substitute for DD

To successfully claim under a warranty, the purchaser must first

- Demonstrate a breach
- Prove that there has been no effective disclosure
- Show there has been a loss which impacts value
- Find someone with enough money to sue; then finally
- Win the court case



Tax Indemnities

Contractual agreement where the seller expresses to pay the buyer for taxes incurred by the target on or before a specific date.

Following to be considered

- Are all types of taxes covered?
- Period of indemnity? – taxes arising after completion from pre completion acts
- Circumstances indemnity is limited? Adequate provisions available? Exclusions considered in purchase price?
- Time period to notify claim



Termination Rights

Right to Terminate the Deal: Depending on the severity of the TDD findings, the buyer may have the right to terminate the transaction (or walk away without penalty) if certain issues arise that were not disclosed or addressed. This is particularly true for material breaches or if tax liabilities significantly affect the value of the business.

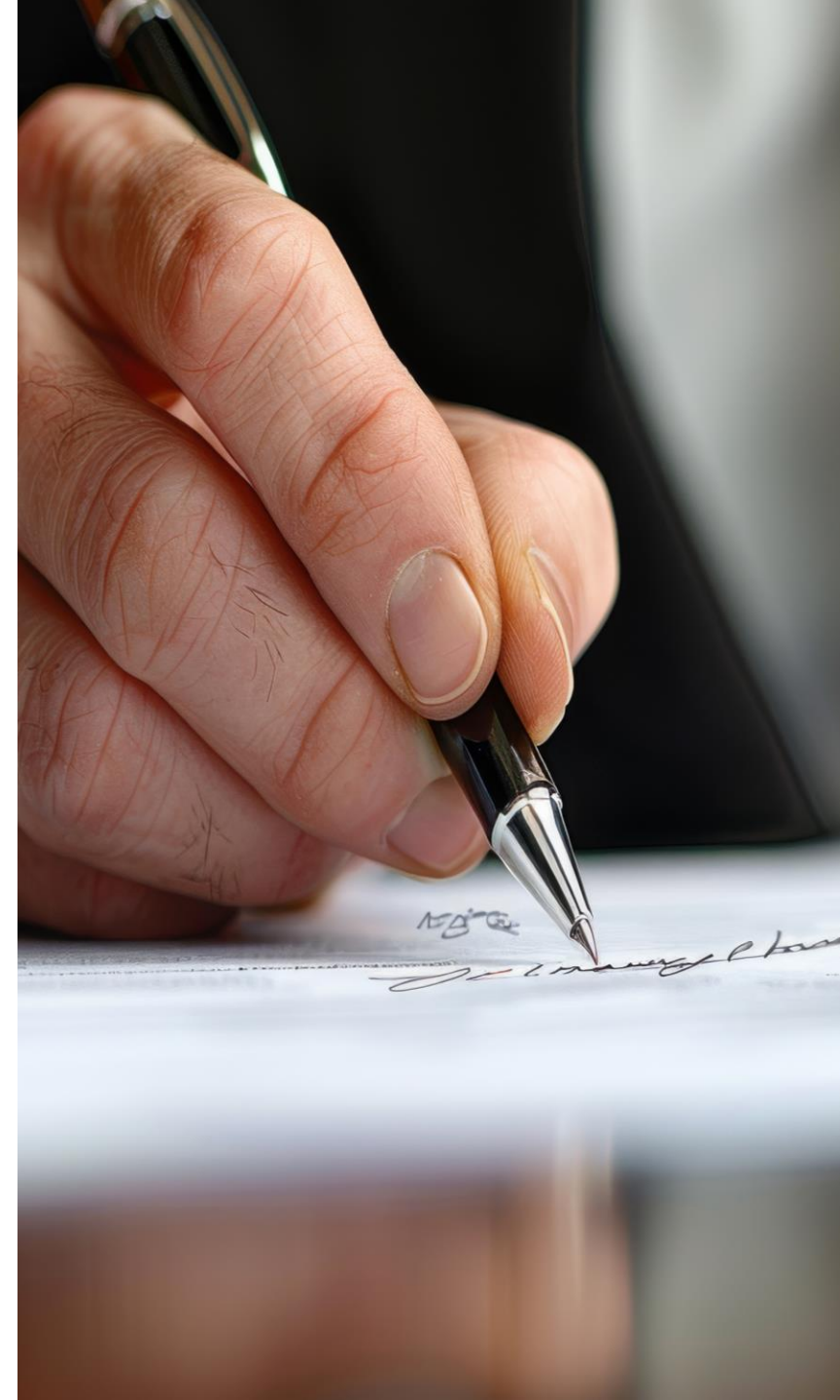
Material Adverse Change (MAC) Clauses: If a material adverse change occurs due to discovered tax issues, a MAC clause may give the buyer the right to cancel the deal or renegotiate the terms.



Tax Covenants and Agreements

Tax Covenant: The buyer may require the seller to covenant that the company will remain tax-compliant up until the closing date, and sometimes for a period afterward. The seller may agree to resolve any pending issues before the deal closes.

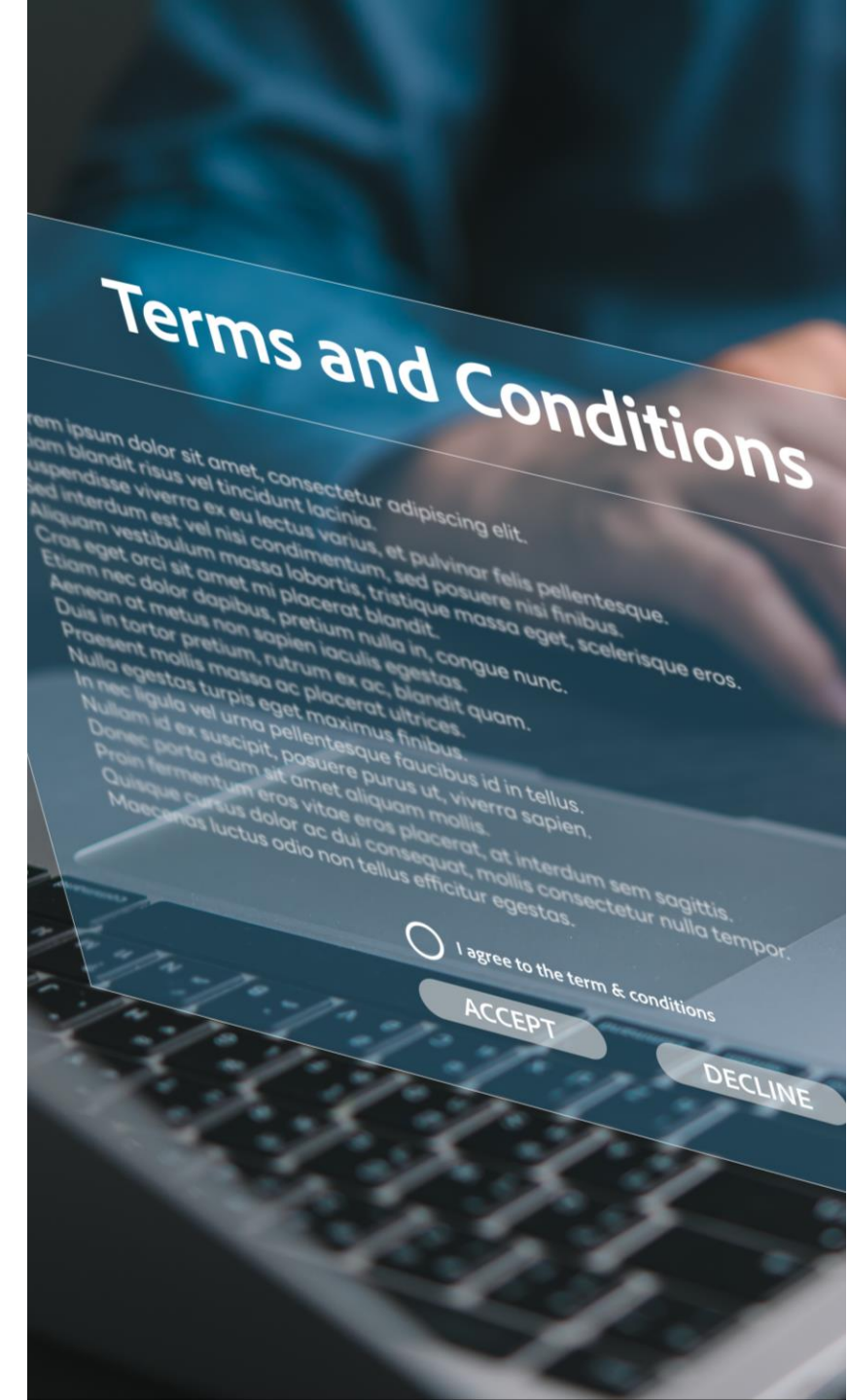
Post-Closing Tax Obligations: In some cases, the buyer and seller may agree on how any tax obligations or penalties from prior periods will be handled after the closing, including who will bear the cost.



Re-Structuring or Renegotiation of Terms

If significant tax issues are discovered, the buyer may propose restructuring the deal to mitigate the tax risks. For example:

- Changing the form of the transaction (e.g., asset deal instead of a share deal) to avoid tax pitfalls
- Changing the closing date or making specific provisions to handle certain tax consequences (e.g., transferring tax losses or credits)



Post-Closing Adjustments or Dispute Resolution

Adjustment Mechanisms:

In cases where certain tax issues are identified post-closing, the parties may agree to a mechanism to adjust the purchase price or compensate the buyer. This could involve a formal claims process within a specified time frame.

Dispute Resolution:

If the buyer and seller disagree on the findings or recourse, they may include an arbitration or mediation process in the purchase agreement to resolve any disputes over the tax findings.



Insurance

In certain instance identified potential additional exposures will be covered through insurance.





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