

TAX DUE DILIGENCE

Moore Kingston Smith's Mergers & Acquisitions (M&A) tax team is a specialist practice that helps clients review and manage the tax risks associated with acquisitions and disposals of a business.

Why do I need tax due diligence?

The purchase of a company or business, can mean that the purchaser inherits exposure to tax positions relating to periods prior to, or events occurring before, the purchaser obtains control. The purposes of tax due diligence is for a professional firm to review the tax affairs of the target in order to give the purchaser comfort as to the tax status of the intended target.

The benefit of tax due diligence

Tax due diligence is not the only way of dealing with a target's tax position and such an exercise may have an impact on the following:

- The scope of the warranties and in particular warranties which are directed at the vendor providing more information about particular areas of concern.
- The inclusion of any indemnities specific to any area of tax where the due diligence has revealed that there is a specific risk. For example, if the target engages a number of contractors there may be concerns as to whether these workers may in reality be employees with the PAYE and national insurance consequences that follow. Additional indemnities may be targeted at this particular area to ensure that the purchaser is fully covered in case a recovery of any tax from the vendor is required.

Whilst the warranties and indemnities may provide the purchaser with a mechanism for recovering any unprovided tax liabilities, it undoubtedly will take time and money to go through the process. The tax due diligence process can also indicate how the consideration is structured, in terms of deferred consideration from which a tax claim can be deducted, or whether any purchase monies should be held in escrow for the same purpose.

Further, tax matters relating to the target which are of concern can lead to a reduction in the price being offered and, in more extreme cases, a total restructuring of the deal (for example from a share purchase to a business purchase) or a withdrawal from the transaction altogether.

Tax due diligence is therefore an important part of the purchase process and can help mitigate the purchaser's risk and provide protection in relation to tax liabilities that may accompany the target. It also allows a purchaser to identify the most favourable structure for the transaction optimising benefits and unlocking previously unclaimed tax recoveries.

Many businesses are now looking internationally to fulfil future growth strategies and buyers need to be aware of both domestic and international tax issues. Utilising MKS's international structure (Moore Global), international aspects can be considered as part of the due diligence assignment.

How much tax due diligence do I need?

The level of tax due diligence work can be tailored to suit the individual requirements of a purchaser, be it a full scope review or a more limited/targetted analysis.

In broad terms the scope of tax due diligence can be divided into the following three categories:

Full due diligence

This would provide an in depth review, outlining the risks and quantify any contingent liabilities and provide advice as to how these may be managed. This would usually involve reviewing most tax issues for the previous four accounting periods or financial years, plus the current year or period. Specific exclusions may be discussed and included within our engagement terms.

Limited due diligence

Purchasers may decide that an exercise with a more limited coverage is appropriate. If so we can adjust our scope to focus on the following:

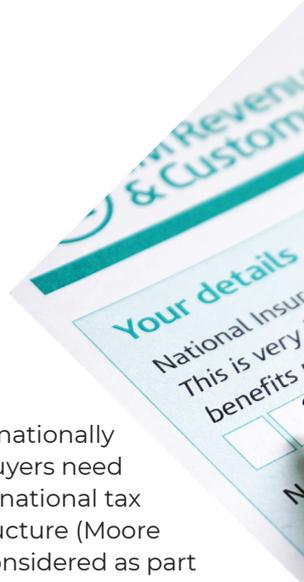
- Looking at more recent accounting periods only and not looking at the previous four years for example.
- Simply reviewing information provided by the vendor in response to our due diligence questionnaire rather than a full examination of underlying returns and computations.

Where limited due diligence exposes areas of risk we can recommend a targeted investigation into these areas. Where this detail is not within the agreed scope, we can bring this to your attention.

Targetted due diligence

It may be that the target company is quite 'young' and the need for detailed due diligence is not so critical. However, there may be a specific area of concern, for example the correct status of contract workers. In this situation it may be appropriate for a purchaser to focus on this area alone.

In all cases our draft due diligence report will be discussed with the purchaser and their legal advisers to consider the impact on the deal structure and the documentation as well as whether any further investigation is required.



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Is this just for purchasers?

Usually, due diligence is an exercise conducted on behalf of the purchaser during a sale process. If issues are identified there can be limited time to deal with them and possible price impacts.

One way of addressing this is for our team to conduct a pre-sale due diligence exercise on behalf of the vendor. This would need to be at an early stage, probably where a decision to sell has been made or where there is a chance that a realistic offer may arise.

The point of such an exercise is to identify matters that can be dealt to make the actual due diligence process less problematic such as:

- Closing HMRC enquiries.
- Keeping a file of important tax documents such as dispensations, tax clearances, transfer pricing policies and agreements with HMRC on specific VAT matters.
- Ensuring dispensations and HMRC forms/agreements are in place and correctly filed.
- Reviewing entrepreneurs' relief or substantial shareholding exemption to ensure that on a sale these valuable reliefs may be secured.
- Considering the incentivisation and retention of key employees so that they stay motivated to achieve the same goal.

Case studies

EMI options

Recently we undertook a review of a company which had granted Enterprise Management Incentive (EMI) options to employees. On review it was discovered that the structure of the deal would not enable the EMI options to be exercised due to poorly drafted conditions within the option agreements.

If the share options were not exercised they would have been deemed unapproved options and therefore not have qualified for the advantageous tax reliefs that an EMI scheme would have secured. A large PAYE charge would therefore have been due within a month of sale.

As this was spotted early we were able to change the mechanics of the deal so that the options could be exercised under the EMI rules to avoid this PAYE charge.

Summary

Tax due diligence is an important component of the overall acquisition or sale process. We work closely with our award winning Corporate Finance team to provide a seamless service that encompasses the commercial, financial and tax considerations of the deal, for the benefit of the client.

Our fees are based on the agreed scope of the assignment and the technical staff required to deal with the complexity of each project.

It should be acknowledged that limiting the scope of tax due diligence increases the potential risk of unexpected tax liabilities materialising, giving the associated problems regarding recovery from the vendor.

If a client chooses to limit the scope of any tax due diligence no responsibility can be taken by Moore Kingston Smith for any matters that are not discovered as a result of this limitation of scope.

Overseas company

A UK target company had a Hong Kong subsidiary, after undertaking the due diligence process we identified that the company could be deemed a UK resident company as there was a significant concern that it was managed and controlled from the UK. If UK resident then all the historic profits were liable to UK corporation tax subject to overseas tax paid.

By identifying this point in advance this enabled us to change the mechanics of the deal and avoid acquiring the 'history' of this overseas entity and the potential corporation tax risk for the earlier years.