Due Diligence in Indirect Taxes
September 2015

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Published by Hiregange Academy
#1010, 1st Floor, 26th Main (Above Corporation Bank),
4th 'T' Block, Jayanagar, Bangalore – 560 041
www.hiregangeacademy.com

First Edition - April 2015

Second Edition - September 2015

Price:Rs. 150/-

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About Hiregange Academy

This world is a competitive world where sustenance is the key. No matter how much one achieves, it is one does with that achievement that matters the most. Hard work, confidence and more so, ‘attitude is the key to success. Right attitude always brings out the best no matter how much of hardships one faces.The present scenario has been such that, the need for the industry though seems to be high, the number of job aspirants is higher.”Knowledge is not Power. Knowing as a concept is only of potential value. The execution and implementation of knowledge is where the power lies. Graduates inspite of being qualified are unemployed or under employed. Those in jobs are underutilized or do not work to their potential.

Hiregange Academy- a knowledge and employability initiative, is in the quest to find and help the job aspirants – to enable them gain self-confidence simultaneously, enhancing their knowledge in the field of commerce, upgrading the skill sets essential to be “job ready”. For those pursuing professional courses facilitate in making them “complete professionals”.

It is a small step taken mainly towards bridging the gap between the industry and the job aspirants. The knowledge inputs, guidance, specific training and solutions to common problems, real life case studies and some technology exposure would ensure enhanced employability of the youth and enhance the quality of already employed. For the industry, “the right resources for the right job” can be achieved.

The Academy aims to provide a win-win-win situation for the job seekers, employers and employees while being a contributor to the nation at large.

Academy was started on19th August, 2014.It is supported by its knowledge partners of Hiregange and Associates, Chartered Accountants, Bangalore and Hyderabad.

The methodology of achieving this would be through: online publications of booklets, free e- books, and specific job oriented training in class rooms (also uploaded on E-tube) at present. Services to CA students/ staff, Colleges and Industry are also being provided. Monthly newsletter to interested persons to spread the latest information is another initiative.

Preface

The need to grow exponentially makes acquisitions and mergers a very important aspect of business. Adding a synergy may make a whole lot of difference. However the downside is that one may end up holding large liabilities and uncertain future if one is not careful. Due diligence exercise in all aspects of business including taxation is therefore imperative. The prospective buyer normally carries out certain agreed upon procedures to assess the deal from commercial, financial, tax and legal standpoints. The business aspects aside a spectrum of tax and regulatory issues such as exchange control, indirect taxes, benefits under Foreign Trade Policy and capital market regulations are also highly impactful. There is no legal binding to carry out the due diligence.

The confirmation after due diligence, that there are no hidden liabilities and that the balances as stated with respect to the indirect taxes are correct would be a matter of comfort.

The well run corporate in normal course would like to ensure that their compliance under indirect taxes is complete. In addition they would be keen to see that there is no loss of margin due to excess payments or eligible credits not availed.

The users of financial statements are becoming more demanding and the liability and responsibility of auditors is being questioned. Auditors appointed for conducting a due diligence may not in some cases be competent to examine areas relating to compliance with respect to indirect taxes.

Hence, this booklet focuses on providing an overview of different methodologies of conducting due diligence under the indirect taxation for the benefit of statutory auditors, investors, financial institutions, governmental organizations and other users of financial statements.

I am grateful to Venkatanarayana G.M for his contribution to this booklet. It is hoped that this booklet would prove to be very useful among the readers and needless to say, comments and suggestions are welcome since they are the barometers of measuring the performance of any literary work.Feedbackwelcome at madhukar@hiregange.com.

About the Author

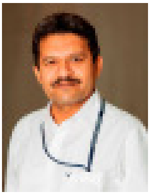
Madhukar N Hiregange - B.Com, FCA, DISA (ICAI) Passed CISA: Senior Partner Hiregange&Associates having offices in Bangalore, Hyderabad, Gurgoan and Visakapatnam. He is associated with few CAs across India as mentor. Faculty at Hiregange Academy a knowledge & employability initiative engaged in training industry officers, professionals, job seekers and students in IDT.

Jointly Authored 15 books on Central Excise, Service Tax, Karnataka VAT and Excise / Service Tax audit. IDT - IPCC Study Material 2nd Edition published by Notion Press. Published a CST Handbook [July 2015] and a GST Primer expected released in September 2015. Earlier contributions include 2 online books on Service Tax and Central Excise – August 2015.

Hiregange has been active in the field of spreading awareness through seminars & articles. He had been a visiting faculty at various Professional and Management Institutes including the IIM Bangalore. He is active in online replies on several professional sites like – pdicai.org, taxmanagementindia.com, caclubindia.com & hiregangeacademy.com.

Was a Central Council Member of the Institute of Chartered Accountants of India for the term 2010-13 with a vision to enhance the credibility of the profession, strengthen the professional in practice and employment, make the course less painful while increasing the quality of the student coming out.

Involved in efforts to make the Indirect Tax laws in India simple, certain and fair and creating an awareness of the potential of knowledge of Indirect Taxes in India for professionals in employment and practice.



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Due Diligence in Indirect Taxes

Introduction

Due diligence is normally associated with takeovers, amalgamations, mergers of entities. It can be said to be a comprehensive appraisal or audit of a business undertaken by a buyer to establish the assets and liabilities of the seller. At times tax considerations are an afterthought which may prove to de-stabilize the amalgamated business especially when the shares takeover route has been followed and the new entity is responsible for the past liabilities.

In recent times the fact that indirect taxes accounts for about 25-30 % of the turnover has prompted medium and large industries to choose to get a due diligence to safeguard their margins. Similarly service sector after getting rude shocks at the time of revenue audits where the cost of IDT could be about 15- 20% have also felt a similar need.

The impact of indirect taxes in businesses is quite substantial. The impact for various industries before and after the introduction of GST would be even more as follows:

a) For manufacturing industries could be upto30% as on date and under GST maybe around 25%.

b) The trader would also see an impact of 22% presently which could rise to 30% under GST.

c) Service providers would be presently impacted upto 20% but under GST they would also rise to 25%.

The net operating loss in the entity to be taken over can be a tax attribute of that entity which can be carried over and may be a sole reason for the takeover. The accumulated credits [Cenvat, Input Tax Credit], existence of tax free status may also be attributes of an entity which are important from the point of a potential advantage to the next entity.

Objectives

The main objective is to "extract" and "build knowledge" about the target company's business operations and weave that knowledge into the important areas of the proposed transaction.

Objectivesin relation to indirect tax laws could be as under:

- ❖ Liability for past acquisitions, reorganization, disposals, restructuring prior to take over need to be stated at proper value.
- ❖ Liabilities for possible disputes, existing disputes, indemnification or obligation like advance license, open EPCG scheme, export obligations, non receipt of H, I & C forms.
- ❖ Assets like credits of Excise, Input Tax Credit (VAT), unexpired tax holiday, retaining tax collected fully or partially.
- ❖ Tax sharing agreements for the past existing as on date. In certain cases the successor is liable for the predecessor's liabilities. (Section 11 in Central Excise & 87 in Service Tax)

- Tax planning opportunities like accumulated credit utilization, huge refunds.
- Utilizing sellers tax structure to advantage.
- Structuring major transactions to manage indirect taxes.
- Managing indirect tax opportunities to enhance the cash flow.
- Planning to manage future indirect taxes.
- Preparing tax ruling and interpretation requests.
- Designing and reviewing systems to help ensure indirect taxes are appropriately collected.

- Test billing or point of sale systems.
- Managing indirect tax audits and other related issues.
- Educating your tax managers through workshops, seminars and manuals.
- Review of significant tax incentives and government subsidies enjoyed.
- Review of deferred taxes.

Need

When a business opportunity first arises, it continues throughout the talks, initial data collection and evaluation commence. Thorough detailed due diligence is typically conducted after the parties involved in the proposed transaction have agreed in principle that a deal should be pursued and after a preliminary understanding has been reached, but prior to the signing of a binding contract.

Reasons

- ❖ To confirm that the business is what it appears to be.
- ❖ To identify potential “deal killer” defects in the target and avoid a bad business transaction.
- ❖ Satisfies the officers’ and directors’ fiduciary duty to make sure any decision made would maximize values to the organization.
- ❖ A duediligence audit is equivalent of checking references before hiring. In general, it focuses on information outside of what is freely presented.
- ❖ To verify that the transaction complies with investment or acquisition criteria.
- ❖ To gain information that would be useful for valuing assets, defining representations and warranties and / or negotiating price concessions.

Value

- ❖ It assesses the risks and opportunities of a proposed transaction.
- ❖ It helps to reduce the risk of post – transaction unpleasant surprises.
- ❖ It is vital that the results of any due diligence process are relevant to the transaction including:
  - Valuation of the target and therefore the purchase price.
  - Sale and purchase agreement (e.g. accountingdefinitions, accounting and tax warranties, indemnities etc.)
  - Integration plan (e.g. deal synergies)

❖ There are a range of circumstances in which companies can benefit from externally provided acquisition due diligence:

- Where any organization is considering an acquisition, merger or joint venture.
- Where the organization or deal manager has limited experience in its undertaking. Where existing advisors face a conflict of interest or are not well placed to undertake it.
- Where its requirement demands technical capabilities and commercial experience beyond the organization's internal resources.

Maximizes Synergy
↓
Develops Additional Negotiating Leverage
↓
Identify, Access and Reduces Risk
↓
Improve/ Validate Valuation Process

How to Conduct Due Diligence

➢ **Start with an open mind -** Do not assume that anything wrong would be found and look for it. What needs to be done is to identify trouble spots and ask for explanations.

➢ **Get the best team of people–** If you do not have a group of people inside your firm that can do the task (e.g. lack of staff, lack of people who know the new business because you are acquiring a business in unrelated areas etc.), there are due diligence experts that you can hire. When hiring such professionals look for their experience record in the industry.

- **Get help in all areas–** Finance, tax, accounting, legal, marketing, technology and any other relevant to the assignment so that you get a 360 degree view of the acquisition candidate.

- **Talk to customers, suppliers, business partners and employees -** Who are great resource points for the preparatory work necessary.

- **Take a risk management approach-**While doing your researches you also need to make sure that you do not antagonize the team of people of the target company by bogging them down with loads of questions.

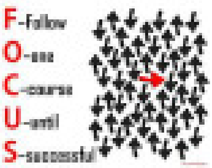
✯ **Prepare a comprehensive report** detailing the compliances and substantive risks / issues.

Focus

Due diligence is a process of obtaining sufficient reliable information about the proposed acquisition to help to uncover any fact, circumstances or set of conditions that would have a reasonable likelihood of influencing the offer or decision to acquire business.

The internally generated information obtained during this process would help to:

- ❖ Verify seller representations.
- ❖ Assist in the determination of value (assets and liabilities).



- ❖ Uncover problems, issues and concerns (current and future).
- ❖ Gain a better understanding of the business and industry, key customers, trends and regulatory requirements.
- ❖ Evaluate management and key employees.

The externally generated informationwould focus on:

- ❖ Public information regarding the company, its principals, key employees and key customers.
- ❖ Market research to gain a better understanding of the dynamics of the marketplace.

Documents

At the beginning of the due diligence process, following documents are normally requested:

- ❖ The latest business plan.
- ❖ Product data sheets and literature.
- ❖ Analysis of competitors.
- ❖ Organizational chart and tax filings.
- ❖ Description of lease and detailed budget and revenue forecasts.
- ❖ Capitalization structure and shareholder information.
- ❖ Historical balance sheet, cash flow and income statements since inception.

- ❖ Forecast balance sheet, cash flow and income statements (possibly upto 5 years).
- ❖ Current operating budgets compared to actual.

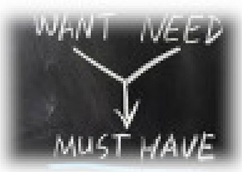
Work Approach

The purchase of a business in many instances is the largest and most expensive purchase asset in lifetime Therefore, assessing the businesses fair value includes:

- ❖ Reviewing and reporting on the financials submitted by the target company.
- ❖ Assessing the business first hand by a site visit (if applicable).
- ❖ Working through the due diligence process with the acquisitioning company or investor by defining the key areas.
- ❖ Helping prepare an offer based on completion of due diligence.

Important points to be kept in the mind:

- ❖ **It is about managing risk–** Double-check financials, tax returns, patents and customers lists and make sure the company does not face a lawsuit or criminal investigation. Extra caution needs to be exercised if the company has never undergone an audit from an outside accounting firm.



- ❖ **Prioritize the people–** Background checks on the company's key officers should be undertaken.

- **Carry out the checks-** With reference to documents and third party verification as appropriate.
- **Prepare to fix the price–** The investor can and do use any flaws that the due diligence uncovers to negotiate the sale price. **Due diligence is chance to get "a better deal".**

Difference Between Due Diligence and Audit

Audit	Due Diligence
Audit is an independent examination and evaluation of the financial statements of an organization with a view to express an opinion thereon.	Due diligence refers to an examination of a potential investment to confirm all material facts of the prospective business opportunity.
Audit is concerned with the truth and fairness of historical financial statements only.	The scope of a due diligence is generally wider – it includes a review of historical figures as one of its elements and also involves analyzing the sustainability of business, competition, business plan, future prospects, corporate and management structure, technology, synergy of target business to company's business apart from researching regulatory compliances, legal issues and other financial data.
An audit involves a study and evaluation of internal accounting controls, detailed tests of accounting records or corroborative evidence through inspection, observation and confirmation which is not usually required in a review engagement.	Due diligence involves review of financial and non financial records as deemed relevant and material. Simply put, due diligence aims to take care that a reasonable person should take before entering into an agreement or a transaction with another party.

Transactions Requiring Due Diligence

- **Mergers and Acquisitions** – The prospective purchaser conducts extensive due diligence. He sends a questionnaire to the target company requesting full details of the business's financials, licenses and collaboration agreements and a whole host of other information. The team doing due diligence then reviews regulatory and press filings, media reports etc. to find out any whether there are any legal and regulatory issues, existing and pending lawsuits and other litigation involving the entity. The team may look for conflicts of interest, insider trading and other problems. In this case, the due diligence is both for buyer and seller.

- **Partnership** - Some of the different types of partnerships where due diligence investigations are appropriate include:

  - Strategic alliances and strategic partnerships.
  - Business partners and alliances, partnering agreements, business coalitions.
  - Just in time suppliers and relationships, sole suppliers, outsourcing arrangements and customers.
  - Technology and product licensing, joint development agreements, technology sharing and cross licensing agreements.
  - Business partners, affiliates, franchisees and franchisers.
  - Value added resellers, value added dealers, distribution relationships.

➢ **Joint Venture and Collaborations** – Before entering into a major commercial agreement like a joint venture or other collaboration with a company, a collaboration partner would want to carry a certain amount of due diligence. This may not be as extensive as on an acquisition, but the larger company would be seeking comfort that its investment would be secure and the small company has the systems, personnel, expertise and resources to perform its obligations.

➢ **Health Check of organisation** - Today with thinning margins and millions of transaction tax rate, levy or credit mistakes can be disastrous. In IDT, the law being vague, possible interpretation can lead to huge demands and fortunes spent on resolving them. It is not uncommon that in the revenue / CAG audits crores of demands are raised which have not been factored in the costs. Many organisations also loose out due to erring on the side of caution.

➢ **Pre Goods & Service Tax Implementation** – The introduction of GST may unsettle many present practices of purchasing and distribution. There may be severe impact downwards as well as upwards. The vigilant is expected to take advantage while the unwary may have to pay a big price. Many well run organisations would like to close out the past and make a fresh start without carrying old baggage. They may get a comprehensive due diligence of the IDT aspects done for smooth transition.

In this booklet, we examine the methodology to conduct a due diligence under indirect taxation by way of:

- General Checklist - For completing the diligence exercise effectively.

- Specific Checklist - After understanding of the important aspects of indirect taxes.

Checklists for IDT Compliance - General Checklist

- ❖ Understanding industry and the clients business.
- ❖ Indirect tax disputes in industry and current status.
- ❖ Corporate structure of the company/ group in India and outside.
- ❖ Internal Control specific to IDT like limits, authorizations, written procedures and inbuilt extent of preventive, detective and corrective checks in place.
- ❖ Extent of IDT reporting in the Management Information System.
- ❖ Extent of information technology system integration to the indirect tax filing.
- ❖ Extent of qualified competent officers in - charge of IDT.
- ❖ External health check/ inclusion of IDT in internal audit scope.
- ❖ Estimate of risk appetite of the company. Review of Contingent liabilities, tax provisions and tax paid in the balance sheet.
- ❖ Analysis about effective tax rate and drawing a cost benefit analysis in indirect taxation.
- ❖ Status and aging of refunds if any.

- ❖ Major agreements including those which are cross border.
- ❖ Customer and vendor profiling and changes in the past year.

Checklists for IDT Compliance - Specific Checklist

- ❖ Last 3 years returns under Central Excise/ CST/ VAT and Service Tax to be reviewed.
- ❖ Reconciliation of returns to financials including carried forward balances.
- ❖ Any advance ruling applied for and obtained / pending before any state or central authority.
- ❖ Past due diligence report if any.
- ❖ Indirect tax review as health check / internal audit if any report to be perused.
- ❖ Each tax file to be checked for adequacy of compliance, completeness and replies examined.
- ❖ Investigation and audits by revenue- reports and their replies to be examined.
- ❖ Any contingent liability in the notes to accounts.
- ❖ Past disputes status, audit queries outstanding not cleared examined.
- ❖ Exception report on management override [putting through special transactions not in compliance with the system] possibilities and listing of instances.
- ❖ Is there any existence of internal audit system at the company? If yes, review the internal audit reports to study the excise implications.
- ❖ Information systems audit report internal/ external if any.
- ❖ Review and analysis of the past 3 years balance sheet as well as profit &loss account other than reconciliation.
- ❖ Tax holiday and period for which available along with value limits if any.

- ❖ Non compete amount paid, transfer of technology, brand and other intangible property impact under CST/ VAT / Service Tax.
- ❖ Obtaining tax representations and warranties from the seller organizations. Possible tax sharing agreements.
- ❖ Tax indemnity for the pre transaction taxes as well as in between the handing over process.
- ❖ Review for registration obtained under Central Excise, Service tax, VAT and Customs provisions.
- ❖ Review the classification of goods sold and rate of tax applied for sale of goods under VAT/CST provisions to ensure accuracy of the same.

This is a brief checklist of the issues which could come up. It is certain that there would be many other issues which need to be verifieddepending upon the type of transactions and this would require additions to this basic checklist above.

Checklists under IDT

Here we examine the possible issues undereach of the indirect tax laws which have a bearing on the values of assets and liabilities stated in the financial statements.

Customs Checklist

- ✓ Classification and rate applicable -The possibility of paying a higher rate of customs duty at present than applicable.

- ✓ Whether the goods imported/ exported are valued as per section 14 of Customs Act, 1962 read with valuation rules.
- ✓ Whether exporter/ importer has obtained Import- Export Code (IEC) number from DGFT.
- ✓ Whether exporter has a current a/c in the designated bank for the credit of any drawback incentive.
- ✓ Examination of exemption, if any, available considering the customer profile.
- ✓ Whether abatement / remission of duty, if any, is applicable to the imported goods destroyed/ lost/ abandoned. Delivery of import manifest in electronic form by the person-in-charge of the vessel or an aircraft. [Before arrival or within 12 hours of arrival]
- ✓ Whether bill of entry is filed electronically under EDI system.
- ✓ Whether correct information is declared in bill of entry and relevant documents are filed with the customs officer for clearance of imported goods.

- ✓ Whether there is violation of any prohibition/ restriction given under customs act, FTP and other allied acts.
- ✓ Whether there is any attachment of property due to violation under customs law.
- ✓ Whether special additional duty refund is availed for sale of imported goods.

- ✓ Where sales are to manufacturers/ service providers, whether the importer has registered under Central Excise.
- ✓ Where imports are from related companies whether the Special Valuation Branch application has been made and followed up.
- ✓ Where imports are without payment of customs duty or at concessional rates such as: EPCG [Export Promotion Credit Guarantee Scheme], Advance License, under 100% EOU scheme- whether the obligations are in line or outstanding or not complied with.

- ✓ Whether company has applied for advance ruling and rulings are complied with.
- ✓ Whethercompany has applied for private warehousing and conditions (like bond, demarcation of the warehouse area) are complied with.

ü Whether goods are warehoused for a period beyond the relevant period as prescribed in section 61 of Customs Act [like 5 years for CGs, etc.

- ✓ Whetherdrawback has been claimed. If yes, whether the conditions have been complied with.
- ✓ Whether bonds or bank guarantees are executed for availing duty free benefits under various export promotion schemes.
- ✓ Whether refund claim has been filed. If yes, ensure that unjust enrichment concept is not violated.
- ✓ Whetherassessee has assessed the duty in terms of section 17 ofCustoms Act. If no, check whether the assessee has

opted for provisional assessment and whether the assessee has complied with the regulation pertaining to provisional assessment.

- ✓ Check whether the assessee has availed the facility of transshipment of goods/cargoto avoid the payment of duty. If yes, check whether the procedure for transshipment of goods/ cargo has been complied with.
- ✓ Check whether the assessee has applied for refund in terms of section 27 ofCustoms Act, 1962. If yes, check whether the same is filed within the applicable time limit.
- ✓ Check whether the assessee is eligible for interest on delay in getting refunds and if yes, whether applied for.
- ✓ Whether there are any valuations or other disputes as on date.
- ✓ If a manufacturer, whetherCenvat credit of CVD + SAD is being availed.
- ✓ If a service provider, whether credit of CVD[SAD credit not available] for usage in provision of services is being claimed.

Central Excise Checklist

- ✓ Whether the entity undertake any activity which results in manufacture of goods.
- ✓ Whether the resultant goods are excisable goods specified in Central Excise tariff Act 1985.

- ✓ Whether the customers are always quoted duty extra.
- ✓ Whether the classification and exemption claimed are legally tenable - Here if any option is available for optimizing tax, it should be examined.
- ✓ All removals are duty paid, reconciliation of goods removed not invoiced maybe necessary.

- ✓ Whether MRP based valuation is applicable.
- ✓ Check if proper abatement is claimed for duty payment when goods are covered under MRP valuation.
- ✓ If not, whether the ad valorem value is an arm's length price not affected by extra commercial consideration from the buyers. [Supply of moulds/ dies/ capital goods / component parts free of cost, advances which depress the price, recovery of advertisement expenses from buyer etc]
- ✓ Whether Cenvat credit of capital goods, inputs and input services are availed completely.
- ✓ Whether the input services liable for reverse charge are paid and credit availed where admissible.
- ✓ Whether the ineligible credits are avoided to be availed- what is the present position of law in that regard.
- ✓ Whether common credits of expenses incurred at HO or other places are availed by going for input service distributor's registration.
- ✓ Whetherproportionate credit under Rule 6(3) ofCenvat Credit Rules is reversible and reversed if the company is having exempted turnover.

- ✓ Ensure that the credits on inputs/input services are availed within 6 months from the date of invoice (effective from 01.09.2014).
- ✓ Check whether payment for input service invoice is made within 3 months of date of invoice as per Rule 4(7). If not, credit to be reversed till payment is made.
- ✓ Check if previous year's deferred credit (balance 50%) is claimed in present financial year in case of capital goods.
- ✓ Whether thegoods sent for job work and their return including scrap is properly accounted and control register maintained along with documentation prescribed.
- ✓ Whether the export benefits such as procurement without payment of duty, duty drawback, Focus Market Scheme, Focus Product Scheme, Incremental Export Scheme are being applied for and obtained.
- ✓ Are the options for import and export being compared for feasibility.
- ✓ Is the correspondence file with revenue indexed and complete[all replies with acknowledgement available].
- ✓ Have all letters seeking information from the revenue been replied comprehensively.
- ✓ Are there any disputes and what is the status [This would also include the outstanding audit notes / objections].Study about different kinds of removal by the company and valuation applicable for each type of removal under excise valuation rules.
- ✓ Review whether the company is filing all the returns and payments within due dates. [Timely filing of returns and making of payments would avoidlitigation]

✓ Study notes to accounts of previous audit report and also about excise duty payable, paid or any other disputes.

✓ Verification of stock reports and checking of valuation of opening and closing stocks is properly accounted.

✓ Touring the factory to know the stages of manufacturing process and raw materials used in the manufacture of final products and also checking documents for security, receipt, stores, consumption, production, quality and dispatch of goods.

✓ Check if any exemptions have been claimed. If yes see whether all the conditions have been met under the exemption notification.

✓ Check if exemption is claimed mandatorily when the exemption is absolute without any conditions attached to it.

✓ Review of tariff heading under Central Excise Tariff and study the chapter notes and deemed manufacture notification 49/2008 C.E (NT).

✓ Check whether goods manufactured falls under 01/2011 C.E with restriction on availment of Cenvat credit and / remove with normal rate with Cenvat benefit. Here, tax benefit analysis to be prepared to take appropriate decision.

✓ See whether company carries assembling and ensure whether such assembling amounts to manufacture or immovable property.

✓ Check whether there any free removal of samples, warranty issues and free issue of material and analyze excise implication on the same.

- ✓ Check is there is any materials consumed captively and study the excise implication on the same. If yes, check if valuation is according to Rule 8 of valuation Rules adopting cost of production plus 10% for valuation of goods.
- ✓ Examine therefund / rebate and drawback options in case there are exports by the unit.
- ✓ Whether registration is obtained for all the units from where goods are being manufactured.
- ✓ Check if auditee is eligible for obtaining registration as large tax payer unit if not obtained already.
- ✓ Check whether any operations are being carried out from unregistered premises/ places.
- ✓ Whether any goods/inputs are stored in unregistered premises/places. Check if they are any implications under Cenvat provisions especially Rule 8 wherein AC/ DC permission is required.

CST / VAT Checklist

- ✓ Whether classification of products and rates are applied proper.
- ✓ Whether any exemption is available for the goods sold.
- ✓ Whether the goods sold within the state are initially removed under CST.
- ✓ Whether registration certificate has listed all items eligible for “C Form”.
- ✓ Have any additionsbeen made as more products purchased which are eligible.

- ✓ Whether exemption for purchases made in the course of import are claimed and eligible.
- ✓ Whether exemption for subsequent sale comply with the conditions under section 6(2).
- ✓ Whetherexemption for procurement in the course of export is availed including penultimate export stage and eligible.
- ✓ Whether form H is issued properly.
- ✓ Whether "C" form is received for all sales at concessional rate of 2 %.
- ✓ Whether full local rate is applied for CST sales without "C" form.
- ✓ Whether value of goods sold is after considering the deductions eligible.
- ✓ Whetherdeduction for sales made through consignment agents and their discharge of VAT evidenced and disclosed.
- ✓ Whether the determination of turnover is proper.
- ✓ Whetherbranch transfers / consignment agent transfers without payment of CST are eligible. [Not against pre-existing order]
- ✓ Are all goods removed for other than sale represented by Form "F" and duly reconciled. [Including those sent for job work interstate]
- ✓ Whether CST paid by adjusting the Input Tax credit available under VAT.
- ✓ Whether the reversal of sale entries made for rejections by filing of revised return within 6 months.
- ✓ Whether all sales to 100% EOU and exporters not under form "H" made on payment of CST.
- ✓ Whether all sales to SEZ are on receipt of form "I" and duly reconciled.

- ✓ Whether the reversal of part of tax paid on inputs not sold in interstate sale such as stock transfer done.
- ✓ Whether the eligible credit for inputs and capital goods availed?
- ✓ Whether the credit for purchases made by consignment agent within the state availed.
- ✓ Whether the ineligible credits are avoided to be availed.
- ✓ If under composition scheme are all conditions of eligibility confirmed.
- ✓ If under composition has it been ensured that input tax credit is not availed.
- ✓ Has the entry tax / octroi / local body tax as applicable for entry to local area been discharged properly.
- ✓ Are the adjustments to such entry tax where permissible been made.
- ✓ Are all tax payments made after adjusting the available credits and returns filed in time.
- ✓ Are all the letters seeking information, proposition notices etc., replied in time and comprehensively.

Service Tax Checklist

- ✓ Are transactions analyzed to see whether a sale, service or combination of both.
- ✓ Where neither, is justification available for exclusion and not charging service tax or VAT. [In case of immovable property transaction]
- ✓ Are the exemptions claimed clearly available and conditions thereto followed strictly.

✓ Are abatements for composite / specified services availed and conditions thereto complied with.

✓ Are transactions where the service receiver needs to pay is identified and ST paid in cash only.

✓ Where eligible is the Cenvat credit claimed on such reverse/ joint charge transactions.

✓ Is the tax being paid at appropriate time especially the continuous supply of service. [As per Point of Taxation Rules]

✓ Are all export of services confirmed as provided outside India as per the Place of Provision of Services Rules.

✓ Are all eligible credits [Capital goods, inputs and input services] claimed including those used for export of service.

✓ Are payments of tax made in time after adjusting eligible credit.

✓ Are the returns filed on or before 25th April and October every year.

✓ Review of various agreements to study the tax implications on such agreements.

✓ Review departmental correspondence file to see whether allcommunication received from the department has been replied within time and no allegation is pending in status quo pro.

✓ Check if there is any declaration filed with the department by the company covering all its activities and business in brief.

- ✓ Check the service provided is naturally bundled or not naturally bundled as per section65Fand implications thereof.

- ✓ Check whether services provided are covered in Negative list of services or in mega exemption notification. If yes the client is at option of availing exemption from payment of service tax [after deciding about cost benefit analysis].

- ✓ Check for any abatement available. If available, check conditions to be fulfilled.

- ✓ Careful reviewing of indirect income head is very much essentialespecially after introduction of declared services, as nowconsideration received towards non– performance of the contractmay also be liable for service tax.

- ✓ Check whether valuation followed in construction industry is correct.

- ✓ Check book adjustments, debit and credit notes to verify implications under service tax.

- ✓ Check is there any reimbursement from the client. If yes, then it should be pure – reimbursement and other considerations as provided in determination of services rules.

- ✓ Examine foreign exchange transactions executed by the company and study the service tax implications w.r.t to POP rules.

- ✓ Check whether the company is following Point of Taxation Rules 2011 wherever applicable.

- ✓ Check clear demarcation of service date in case of continuous services provided and service tax discharged on advances.

- ✓ Check whether the company has the system of reconciliation.
- ✓ Find out is there any continuous supply of services. If yes, check if the point of taxation rules has been followed by the company.
- ✓ Check, are there any related party transactions. The liability of service tax would be on booking of accounting entry basis.
- ✓ Checkwhether the company has availed any ineligible input service credit. If yes, the same needs to be reversed along with interest.
- ✓ Make a list of all taxable services provided by the auditee with a brief write-up and check for the exemption under mega exemption notification or any other specific notification.
- ✓ Check whether any book adjustments/ debit note / credit note raised on the customers.If yes, check the service tax implication on the same.
- ✓ Check whether reimbursements are received from the clients. If yes, check whether the same is included for discharging service tax.

- ✓ Check whether deduction has been claimed as pure agent on reimbursements. If yes whether all conditions regarding pure agent was satisfied.
- ✓ Check if any income/considerations are received towards taxable services without charging service tax separately in the invoice.
- ✓ Check whether the entity is following accrual system for paying the service tax or whether cash system as per Rule 6(1) (ii) of ST Rules 1994upto Rs.50 lakh turnover followed.

✓ Check if taxes are paid using correct category of services and correct accounting code.

Conclusion

The due diligence reports would form a valuable tool for the new owners of the business in providing an overview of the business and identification of areas ofweaknesses and threats which would have to be addressed. Each due diligence review is unique but the overall aim is to provide sufficient, relevant and timely information.

The successful performance of a due diligence investigation is dependent upon the scoping, co-ordination and planning of the review and the use of a highly skilled team. The cost of the preparation of a quality due diligence exercise is insignificant when compared to the cost of a bad acquisition.

Thus, the due diligence of indirect taxes could be a critical and important part of the exercise as can be envisaged after going through the above aspects.

In today's competitive world the cost of dispute or loss of credit could make a difference between profit or loss. Consequently many medium and large scale manufacturers and service providers consider a due diligence of indirect taxes a value additive effort. It is also called a limited review of indirect tax compliance or IDT health check.

A check list used for the health check under IDT has been provided as appendix which may be used after modification as necessary. The checklist is not a due diligence checklist.

IDT Review Check List

INDIRECT TAX REVIEW CHECK LIST	
Name of the concern	
Address	
Contact Persons	
Phone numbers	
E-mail Id	
Nature of Business	
Audit team	
Date of commencement of review	
Date of conclusion of review	
Review period	

Sl. No.	PARTICULARS	Reviewed by	Remarks, If Any
1.	**Review of various reports**		
A	Review of our previous audit reports to ensure compliance of the issues reported		
B	Review of statutory audit report to ascertain the position on statutory dues (Excise, Customs, ST and VAT) and to ascertain the existence of related party transactions which could have impact on valuation of goods/ services etc.		
C	Review the annual stock reports/ statements to ascertain whether differences exist between book stock and actual stock figures as the same could have tax implications		
D	Review of internal audit reports to ascertain the indirect issues noted by internal auditors and compliance of the same		
E	Review of VAT audit report or VAT annual return to ascertain the issues reported by the auditor and compliance of the same		
F	Review of audit notes/reports issued by the tax authorities and compliance of the same		

2.	**Registration under indirect tax laws**		
A	Review for registration obtained under Central Excise, Service tax, VAT and Customs provisions		
B	Review if the registration has been obtained for all the categories of service on which assessee is liable to pay service tax		
C	Review for option of centralized registration, Input Service Distributor registration under the service tax provisions		
D	Review if all the additional place of business in the state have been included in VAT registration certificate		
3.	**Review of Classification, Rates of tax, Valuation, Taxability of Goods and Services**		
A	Review the classification of goods manufactured and the rate of excise applied to ensure accuracy of the same		
B	Review the exemptions being claimed and examine for exemptions if any available for the goods manufactured		

C	Review the valuation mechanism applied for the goods manufactured to ensure that the same are in accordance with Excise Valuation provisions		
D	Review the classification of goods sold and rate of tax applied for sale of goods under VAT/CST provisions to ensure accuracy of the same		
E	Review the exemptions being claimed and examine for exemptions if any available for the goods sold		
F	Review the valuation mechanism applied for the goods sold to ensure that the same are in accordance with VAT/CST provisions		
G	Review the classification of services and rate of tax applied for the services provided under Service tax provisions to ensure accuracy of the same		
H	Review the exemptions/ abatements being claimed and examine for exemptions or abatements if any available for the services being provided		
I	Review the valuation mechanism applied for the services being provided to ensure that the same		

	are in accordance with Service tax valuation provisions		
J	Review the contracts/ agreements with customers/ clients/foreign service providers to - ● Ascertain the taxability of services provided and also the services which are received from outside India ● Ascertain if any additional consideration being received and impact of the same on valuation of goods or services		
4. a.	**Review of other correspo-ndences with tax authorities** Review the excise correspo-ndence file to evaluate issues that can arise or have arose in the past		
b.	Review the service tax corres-pondence file to evaluate issues that can arise or have arose in the past		
c.	Review the KVAT correspo-ndence file to evaluate issues that can arise or have arose in the past		

d.	Review the Customs correspondence file to evaluate issues that can arise or have arose in the past		
5.	**Reconciliations of records under indirect tax**		
a.	Review the reconciliation undertaken for the amounts between the following documents (Excise): ● Excise returns with Financial statements ● CENVAT credit register with Excise returns ● Invoices with CENVAT credit register ● DSA with Excise returns ● Excise invoices with DSA		
b.	Review the reconciliation undertaken for the amounts between the following documents (Service tax): ● ST-3 returns with Financial statements ● ST-3 returns with CENVAT credit registers ● ST-3 returns with Excise returns for CENVAT credit		

c.	Review the reconciliation undertaken between the KVAT return and financial statements. Reasons for differences if any to be ascertained		
d.	Verify at random the physical stocks and compare with stock as per books - ● Raw materials ● Finished stock ● Semi-finished stock (where possible) ● Capital goods/machinery		
6. a.	**Review of financial statements** Review of balance sheet to – ● Identify the assets purchased and ascertain the eligibility of KVAT input set off and CENVAT credit claimed on such assets ● Identify investments made in associates/group companies if any. If any investments are made, then ascertain the impact of central excise valuation for clearances made to such associates or group companies.		

	• Identify the major customers/ clients to trace the realizations and the pattern of charging them to study the implications under indirect tax laws.		
b.	Review of Profit of Loss account– • Ascertain the nature of revenue - Sales, Service and other incomes. • Review for existence of exempted clearances of goods/exempted services/ stock transfers/other sales etc. • Review for insurance claims made and received on damaged goods or assets. • Ascertain the nature of expenditure and study the eligibility / ineligibility of CENVAT credits and VAT input setoff. • Review for payments made in convertible foreign exchange outside India and study the implication under reverse charge mechanism in service tax. • Review for other expenditures which are liable		

	for service tax under partial reverse charge mechanism like Rent-a-cab services, GTA services, Works contract services, Sponsorship services etc. ● Review for purchases made from unregistered dealers under VAT to ascertain the liability as a buyer of goods. ● Review for purchases wherein the TDS provisions as per VAT laws are applicable.		
c.	Review the debit notes – ● Ascertain additional consideration/amounts debited to clients/customers to study the impact under indirect laws. ● Review of Reimbursement of expenses to ascertain the impact under reverse charge mechanism under Service tax provisions. ● Review for purchase returns to study impact of CENVAT credit and VAT input setoff claimed on the same.		

d.	Review the credit notes - ● Review for Sales returns to study impact of CENVAT credit of excise duty paid on clearance and deduction available under VAT/CST provisions. ● Review of instances where in the credit notes are issued after renegotiation of amounts charged to customers/clients to study the impact of indirect tax laws on the same		
e.	Review the journal register to find out cases of stocks written off/ destroyed or stocks transferred to trading or other units/branches etc.		
7. a.	**Review of CENVAT Credit and Input tax setoff** Review the purchase and expense invoices to evaluate the eligibility of CENVAT credit in accordance with CCR 2004.		
b.	Review the purchase invoices to evaluate the eligibility of input tax setoff in accordance with VAT provisions.		
c.	Review the GRNs' to ensure that credits/set offs have been claimed in case of all purchases		

	Alternatively, the financial ledgers of the vendors could be verified to ensure that the CENVAT credits or VAT input tax setoffs are taken on all eligible purchases.		
d.	Review whether the set off under KVAT has been claimed in accordance with provisions of VAT when exempted activities are involved		
e.	Review whether credits have been taken on sales returns under Central Excise provisions and if so, whether an invoice from customer available or own invoice reference found adequate		
f.	Review the raw materials ledger to find out if the goods on which CENVAT credit and input tax setoff is claimed are issued towards exempted activities		
g.	Review of job work register to ascertain whether the CENVAT availed goods sent for job work are received within the time stipulated under CCR 2004		
h.	Review the profit margins in case of purchases from excise dealers to ensure that high margins are not charged and explore the possibility of alternative suppliers if high margins are involved		

8. a.	**Review of Sales invoices, service bills, delivery challans etc.** Review of excise invoices/sales invoices/service bills to ensure that they are prepared in accordance with provisions of indirect tax laws.		
b.	Verify sales invoices/stock transfer notes with the delivery challans (if any) to ensure compliance under Indirect laws.		
C	Review the security registers to find out cases of goods removed on non-returnable basis without sales/excise invoice to ascertain implication under Indirect laws. Review for transactions wherein the goods are being removed as samples and the indirect tax implications on such transactions.		
9. a.	**Review of job work transactions** Review the job work register and challans to find out cases where materials are pending for receipt beyond the stipulated time limit as per CCR 2004.		
b.	Review the VAT delivery challans /stock transfer forms and cross verify the same with the excise job work challans (if maintained separately) to ensure accuracy		

c.	Review the security returnable registers to find out instances wherein the materials are sent out without proper job work challans		
d.	Review the treatment of scrap generated by the job worker to ensure that proper duties are paid wherever it is payable		
e.	Ascertain if the process at the job worker's end amounts to manufacture and if so evaluate whether duty is paid or if not paid whether declaration is provided to job worker?		
f.	Review whether the assessee takes up job work/sub-contracting for others and if so: ● Ascertain if the activity amounts to manufacture or not as the same would have implication under indirect tax laws ● Ascertain if proper taxes are being discharged based on the nature of activity		
10. a.	**Review of Exports/Deemed Exports, Imports and other benefits under Foreign trade policy and Customs** Review if proper documents are maintained in case of export of goods outside India claiming exemptions		

b.	Review if proper documents are maintained in case of deemed export of goods without payment of taxes. Review for existence of exemption certificate and other documentation		
C	In case of exports, Review if the assessee is eligible for refund of VAT paid on inputs and refund/ rebate of CENVAT credit of tax paid inputs and input services		
D	In case of imports, Review if the CENVAT credit of import duties paid are eligible for credit and the same are claimed properly		
E	If the assessee is engaged in exports, Review for various export benefits available under the foreign trade policy		
F	Review for valuation of imported goods to ensure that proper value is declared for payment of import duties		
G	Review for any exemptions available for import of goods		

Audit in-charge **Audit partner**

Signature **Signature**

Other Stages in Review:

1. Desk Review
2. Conduct of the review/ audit
3. Discussion of concerns and management representation
4. Issue of Draft Report
5. Discussion with Finance & Top Management
6. Follow Up Review for ensuring compliance/ value addition.

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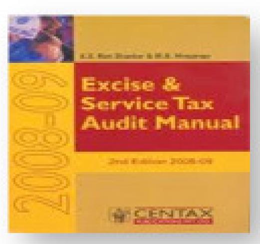

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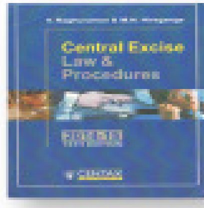

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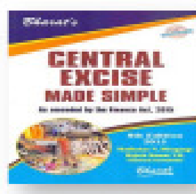

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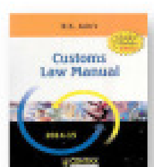

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Additional Resources

❖ **Google – Useful Links!!!**

➢ http://indiacorplaw.blogspot.in/2010/07/guidance-on-due diligence.html

➢ http://www.caaa.in – indirect taxes – due diligence

➢ www.icai.org - generic guides

❖ **Publication of Booklets:**

➢ To get free downloads of the booklets published, click the below link: www.hiregangeacademy.com

➢ Hard copies of the booklets are also available for sale at Hiregange Academy office.