Chapter

The Management of Tax Risks in Mergers and Acquisitions - The Importance of Tax Due Diligence

Arnaldo Marques de Oliveira Neto

Abstract

The purpose of this chapter is to demonstrate the importance of tax risk management in mergers and acquisitions processes by conducting an investigative work called due diligence. To achieve this objective, bibliographic and documentary research was used, as part of exploratory research. In topic 1 it is evidenced that the complexity of tax systems around the world has demanded increasing attention from companies to avoid undesirable cash disbursements for payment of infringement notices arising from questioning by tax authorities related to improper procedures of companies when paying taxes. Additionally, it has required them to be diligent in identifying lawful tax planning alternatives to optimize the tax burden on their operations. In topic 2 the responsibility of company administrators in the management of tax risks is exposed. Topic 3 explains the importance of accounting, tax and legal due diligence in merger and acquisition processes. Finally, topic 4 analyzes the main aspects of due diligence in the tax area. In view of all the exposed in this chapter, it will remain clear to readers the importance of the tax due diligence of the target company, as a way to minimize risks in the decision-making process of the managers of the purchasing company that may compromise the success of the merger and acquisition operation, as well as not subjecting them to administrative and judicial suits, for non-compliance with their fiduciary duties of diligence and loyalty in relation to the company of which they are executives. Additionally, the study's results suggest that companies—in compliance with the guidelines and limits set by the board—choose the appropriate and specific techniques of risk management, especially those related to minimization, immunization, and transferring these risks. The recommendations derive from the need to identify and manage tax risks, from the point of view of good corporate governance practices. This study may serve as a reference to companies in general, when studying, developing, and implementing recommendations for the identification and minimization of tax risks, as well as in the development of a work program that allows them to conduct due diligence work in target companies.

Keywords: tax system, tax risks, tax due diligence, managers responsibilities, merger and acquisition

1. Introduction

The complexity of tax systems around the world, as well as their constant changes, has demanded increasing attention from companies and their managers to avoid undesirable cash disbursements for payment of infringement notices arising from questioning by tax authorities related to improper procedures of companies when paying taxes. Additionally, it has required them to be diligent in identifying lawful tax planning alternatives to optimize the tax burden on their operations [1].

In the case of Brazil the complexity and dynamism of the its tax system is growing in sophistication, especially after the implementation of the Public Digital Bookkeeping System (SPED) and has occasioned the need for companies to organize their business under appropriate tax governance for effective and efficient tax compliance, in order to maximize the legitimate economy of taxes and minimize the risk of possible questioning by the tax authorities, which may result in identification of tax contingencies and the consequent issuance of notices of violation (infringement notification), with a corresponding recovery of punitive fines and penalty interest [2].

SPED was established by Presidential Decree No. 6022/2007 and regulated by Normative Instruction of Internal Revenue Service of Brazil No. 787/2007, such as a smart tool that unifies the activities of receipt, validation, storage, and authentication of books and documents that comprise the commercial and fiscal bookkeeping companies through unique and computerized information flow.

The globalization, a typical feature of modern society, made the concept of risk society that, from the perspective of taxation and in relation to its aspects of ambivalence, indeterminacy, and uncertainty, affects taxpayers, creating juridical insecurity and confusion in meeting their tax obligations [3].

Risk can simply be defined as exposure to change. It is the probability that some future event or a set of events will occur. Therefore, risk analysis involves identifying potential adverse changes and the expected impact as a result in the organization [4].

The term 'risk' comes from the word *risicu* or *riscu*, in Latin (which means 'to dare', in English). It is customary to understand 'risk' as the possibility of 'something does not work,' but its current concept involves the quantification and qualification of uncertainty, both regarding 'loss' as the 'earnings,' in relation to the course of events planned, either by individuals or by organizations [5].

When investors buy stock, surgeons perform operations, engineers design bridges, entrepreneurs open their businesses, and politicians run for elected office, the risk is an unavoidable partner. However, their actions reveal that the risk need not be so feared today: managing it has become synonymous with challenge and opportunity [6].

The objective of the study contained in this chapter is to demonstrate the importance of tax risk management in mergers and acquisitions processes by conducting an investigative work called due diligence.

To achieve this objective, bibliographic and documentary research was used, as part of exploratory research, since information and previous knowledge were collected about the problem for which the answer was sought, as well as materials that have not yet received analytical treatment, such as laws, regulations, and official decrees [7].

So, in this topic 1 it is evidenced that the complexity of tax systems around the world has demanded increasing attention from companies to avoid undesirable cash disbursements for payment of infringement notices arising from questioning by tax authorities related to improper procedures of companies when paying taxes. Additionally, it has required them to be diligent in identifying lawful tax planning alternatives to optimize the tax burden on their operations.

In topic 2 the responsibility of company administrators in the management of tax risks is exposed. This topic initially demonstrates that good corporate governance practices attributed to the board of directors and, in its absence, the senior management of the organization, the fundamental task of identifying, prioritizing, and ensuring effective management of various risks that may affect its business and even its continuity. It points out that through tax governance, the company aims to identify the most beneficial tax incidence hypothesis, to allow their activities may be lawfully benefited by the reduction in tax burden or inserted in the context of no tax levy. The company should also minimize the generation of tax contingencies. Finally, it points out that managers—in compliance with the guidelines and limits set by the board—should choose the appropriate and specific techniques of risk management, especially those related to minimization, immunization, and transferring these risks.

Topic 3 explains the importance of accounting, tax and legal due diligence in merger and acquisition processes. He points out that the due diligence work has some important functions. Firstly, it serves to uncover risks of various natures and helps in the decision-making process in terms of shaping the agreement and finding a realistic price for the acquisition, because it allows for a better assessment of the target object. The slighting of asymmetries of information may be seen as a direct effect of due diligence. Then, he comments on the relationship between the parties involved, the need to hire a multidisciplinary team of specialists, the areas to be examined, the preparation of the pro forma balance sheet, the writing of the report and the sizing of the guarantees.

Topic 4 analyzes the main aspects of due diligence in the tax area. It highlights issues to be observed as measurement of liabilities and assets accounted for, identification of unaccounted assets and liabilities and disclosure of contingencies not quantified.

2. The responsibility of company administrators in the management of tax risks

Regarding 'risk management', there are regulations in Brazil, for example, that are in line with the Sarbanes–Oxley Act (SOX) and the Basel Agreement (for financial institutions). The SOX was published in 2002 in the USA, in response to some corporate scandals. It introduced important changes for the regulation of financial practice and corporate governance of companies. It emphasized the critical role of internal controls [8].

Internal controls include the organization plan and all methods and measures adopted in the company to safeguard its assets, verify the accuracy and fidelity of accounting data, develop efficiency in operations and stimulate the follow-up of prescribed executive policies [9].

This is one of the reasons the administration, notably of the large companies, have become more complex and difficult, requiring professionals with expertise in various areas of knowledge, causing the separation of ownership (owners) and management (executives) to allow business to be conducted in a more professional manner [10].

2.1 Good corporate governance practices

The Organization for Economic Co-Operation and Development (OECD) emphasizes that a good corporate governance system enables corporations to operate for the benefit of the community, with investor confidence, and attract stable long-term capital. It stands out for the range of topics dealt with and their influence on the global dissemination of the principles of good corporate governance practices. According to the OECD, governance fixes as a link of development of bond markets, corporations, and nations [11].

The adoption in 2002 of US Law SOX, printing new coherence to the rules of corporate governance, as renewal element of good practices of legal compliance, provision accounts (accountability), transparency (disclosure), and sense of justice (fairness) [12].

Good corporate governance practices attributed to the board of directors and, in its absence, the senior management of the organization, the fundamental task of identifying, prioritizing, and ensuring effective management of various risks that may affect its business and even its continuity. In this vein, the responsibility of the board and the senior management members—from both a corporate and a tax perspective—loomed in the risk society. From the tax point of view, there may be the extent of the responsibility of the legal entity to its partners, directors, officers, or legal representatives in some situations, which may even result in the blocking of their personal property, including their bank accounts, among other measures [13].

For example, the article 135 of the Brazilian tax code prescribes that "they are personally responsible for claims relating to tax liabilities arising from acts performed with excess of power or violation of law, article of incorporation or bylaw: directors, managers, or representatives of legal persons of private law".

2.2 Tax governance to optimize the company's tax burden

A species of the genus corporate governance, tax governance is the way in which organizations are led, directed, and managed to optimize their tax burden, identifying opportunities for their reduction, and minimizing the possibility of tax contingencies (risks) [14].

Through tax governance, the company aims to identify the most beneficial tax incidence hypothesis, to allow their activities may lawfully be benefited by the reduction in tax burden or inserted in the context of no tax levy. The company should also minimize the generation of tax contingencies [15].

The tax governance considers all aspects of the issue, from a legal, tax, accounting, financial, and economic outlook considering domestic and international experience in order to minimize risks and maximize the legitimate tax savings, following high ethical standards and in full compliance with the letter and spirit of applicable laws [16].

The international surveys by large accounting firms indicate that the management of tax risks has been gaining more importance on the board. Senior executives are increasingly looking for information about taxes, because of its potential material impact on the financial statements and the tax issue can no longer focus exclusively on tax compliance and managing the effective rate of taxes. CEOs and board members are doing more complex questions about how your organization manages its exposure to tax risk [17].

The OECD has stressed the importance of the involvement of the board in tax strategies of multinational companies: 'Encourage the board, the CEO, and the audit committees from the large companies to have more interest and responsibility for their tax's strategies'. There is a clear expectation that the OECD will expand its guidelines on corporate governance for the tax area of the companies soon [18].

2.3 Tax risks management

Tax risks include the risk of paying more or less tax than legally required. Damage to reputation resulting from such errors may cause additional costs which are difficult to measure. Errors in assessing the tax effects of transactions may lead to wrong business decisions. For many companies, the tax is a cost factor which may be important for their competitiveness. Tax risks consist primarily of compliance, transactional, operational, and reputational risks. These are good reasons for the board is involved in the management of tax risk [19].

The risk appetite is associated with the level of risk that the organization can accept in the pursuit and achievement of its mission/vision (activity more associated with prior risk analysis). The risk tolerance is in line with acceptable levels of variability in achieving the goals and objectives defined (activity more associated with risk monitoring). Together, these two components defining the organization's risk profile, in relation to the exposure to the risk that it accepts, as **Figure 1** displays [20].

Managers—in compliance with the guidelines and limits set by the board—should choose the appropriate and specific techniques of risk management, especially those related to minimization, immunization, and transferring these risks [21].

The tax governance will have to cover the tax philosophy and strategy of the company, internal policies, and procedures regarding tax risks and external communication regarding all tax matters. The board of directors will be responsible for defining a direction, the implementation of a tax system of governance and of course for enhancement of company value, through tax reduction [22].

Therefore, efficient, and sustainable company from the tax point of view (regardless in which country it is located) is one that seeks to identify with the requisite notice the legal and tax alternatives less costly to achieve their business objectives and adopt a set of coordination procedures, control and review in order to minimize the possibility of generating tax contingencies. We remind you that from the owners' point of view the obligation of senior management of the company to plan its business, to increase—in a continuous, permanent, and sustainable manner—its revenues and reduce their costs (including taxes), to make it increasingly profitable [23].

The corporate sustainability can be defined as the ability of companies of creating value for its owners over the long term, through proper management of risks associated with economic, social, and environmental factors, as shown in **Figure 2**. Soon, the company, concerned with sustainability, investing in its continued ability to continue growing. There is a natural convergence between sustainability and

Figure 1.
Corporate risk management model resulting from appetite and tolerance to risk. Source prepared by the author.

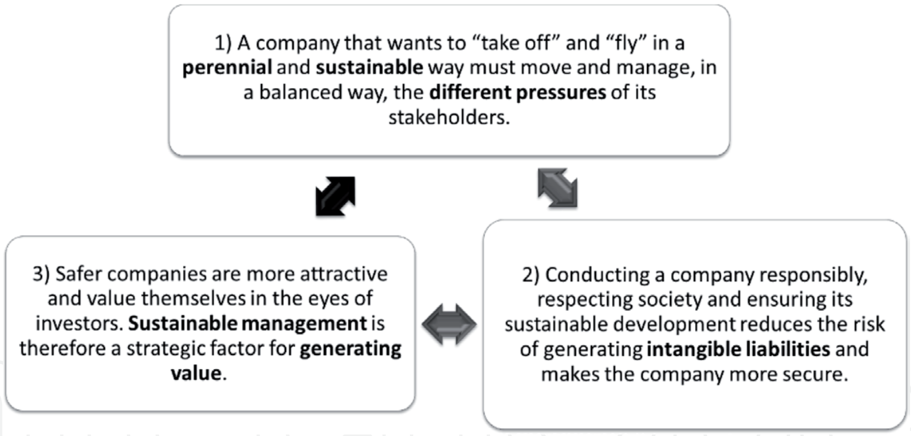

Figure 2.
Convergence between sustainability and implementation of corporate governance practices. Source prepared by the author.

implementation of corporate governance practices. From an economic standpoint, we can say that there is no sustainability without profitability [24].

Intangible liabilities (mentioned in the above **Figure 2**) mean the requirement whose information about its existence remains hidden from the user of the financial statements and, in some cases, even from its managers [25].

Because of all that has been exposed so far in this chapter, considering the responsibility of company administrators in the management of risks it is especially important do carry out a due diligence procedure, on which we come to deal with in the next topic.

3. The importance of accounting, tax and legal due diligence in merger and acquisition (M&A) processes

It is usual in commercial practice, mainly in mergers & acquisitions, to carry out a procedure for collecting information and reviewing and analyzing documents, with the function of verifying the legal and economic situation of the companies involved in the business, called due diligence [26].

Due diligence, used in mergers and acquisitions processes, as one of the last stages of the transaction, from the accounting, tax, and legal point of view, aims primarily to identify contingencies that are capable of affecting the value of the assets involved in the business, as is outlined in **Figure 3**. It is not too much to remember that, in the legislation of several countries, there are several situations in which the buyer becomes responsible for the seller's liabilities [27].

From a tax perspective, the economic advantage of an M&A transaction depends on the potential tax risks and opportunities of the targeted transaction that are identified during the transaction stage, the costs that are incurred on account of conducting the due diligence itself, as well as the tax savings that may be realized when consuming the target transaction, minus the requisite restructuring costs that are incurred during the integration stage. The latter are determined by the extent of pre-acquisition and post-acquisition measures [28].

From the seller's point of view, due diligence, prior to the signing of the closing of the transaction, may be used as a defense against future (any) claims by the buyer. Thus, it aims to ensure that the information has been audited by the buyer, serving to protect the seller from any claim of ignorance from the part of the buyer [29].

Due diligence is of the buyer's priority interest, as it is verified, at this stage, whether the data provided in the information memorandum are compatible with

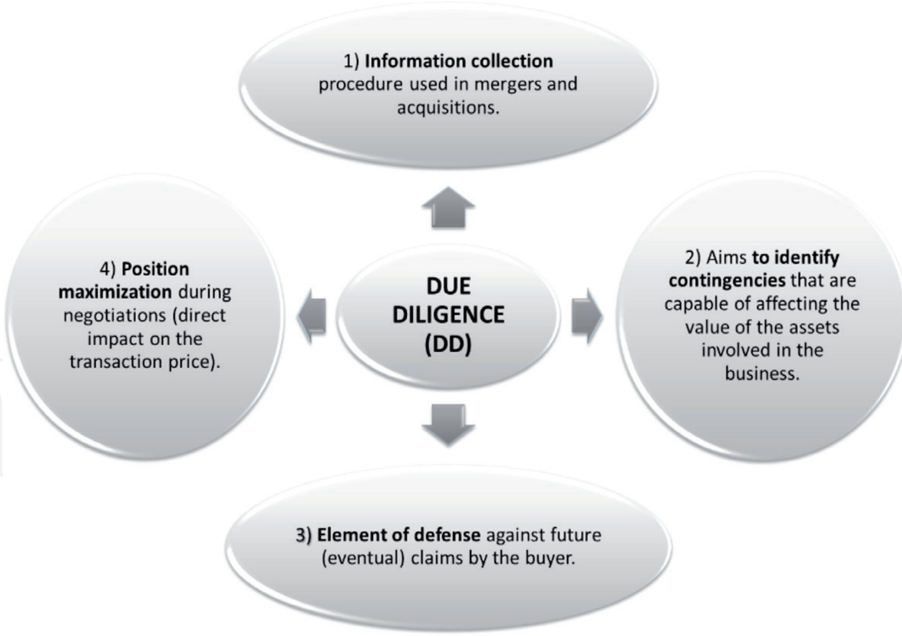

Figure 3.
Verifying procedure company's situation from several angles. Source prepared by the author.

the reality. Buyers seek to protect themselves from optimistic projections from sellers through earn out mechanisms and possible non-compliance of current and past data through due diligence. Due diligence grants the acquirer access to sensitive information about the object to be acquired, for the purpose of being able to conduct a comprehensive audit [30].

Due diligence is conducted by the buyer and accompanied by the seller. The latter should be diligent in the provision of information so that the earn out mechanisms are not applicable at a future date. It is therefore advisable to conduct the work in such a way as to ensure that the parties have extensive knowledge of what is being negotiated and the risks involved [31].

In that regard, due diligence has some important functions. Firstly, it serves to uncover risks of various natures and helps in the decision-making process in terms of shaping the agreement and finding a realistic price for the acquisition, because it allows for a better assessment of the target object. The slighting of asymmetries of information may be a direct effect of due diligence [32].

3.1 The relationship between the parties involved

The opposition of interests between the parties involved ends up being reflected in the performance of due diligence work. Generally, the due diligence is interested in detailing the legal, accounting, tax, labor, social security, financial, etc. situation of the target company. On the other hand, the latter always has the interest to protect itself [33].

The wear and tear in the relationship can be minimized through the establishment of confidentiality agreements, agreed before the start of the due diligence work, as well as by the stipulation of rules for the flow of documents and information between the parties, to avoid delays and conflicts [34], as summarized in **Figure 4**.

3.2 The formation of a multidisciplinary team of specialists

Given the scope and diversity of aspects to be observed during due diligence for the purpose of conducting a work of this nature, it is necessary to hire a multidisciplinary team of professionals, usually composed of auditors, tax consultants and lawyers (specialized in the most diverse areas of law) [35], as show in **Figure 5**.

The role of accounting auditors, objectively speaking, is to verify how the operations of the investigated company are processed (through its accounting system, which gives rise to the financial statements), from the point of view of meeting the fundamental principles of accounting and accounting agreements. For this, they will perform, among others, the following steps: examination of corporate documentation, operational plans, product description, financial statements, contracts, accounts relating to suppliers and customers, physical inspection of facilities, etc., addressing of matters to be analyzed in more detail by tax consultants and legal advisors, as well as receipt of inputs from the latter, which may represent adjustments for the purposes of the pro forma balance sheet [36].

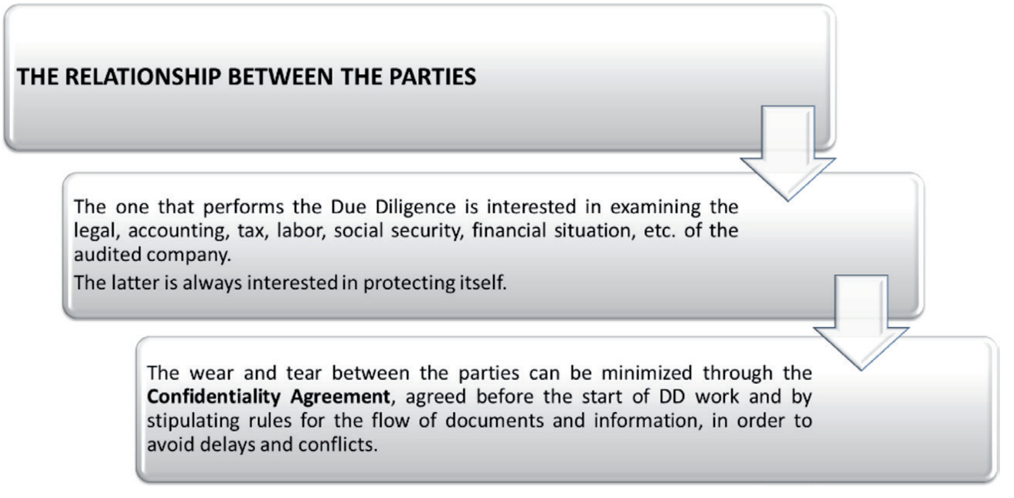

Figure 4.
The relationship between the parties involved. Source prepared by the author.

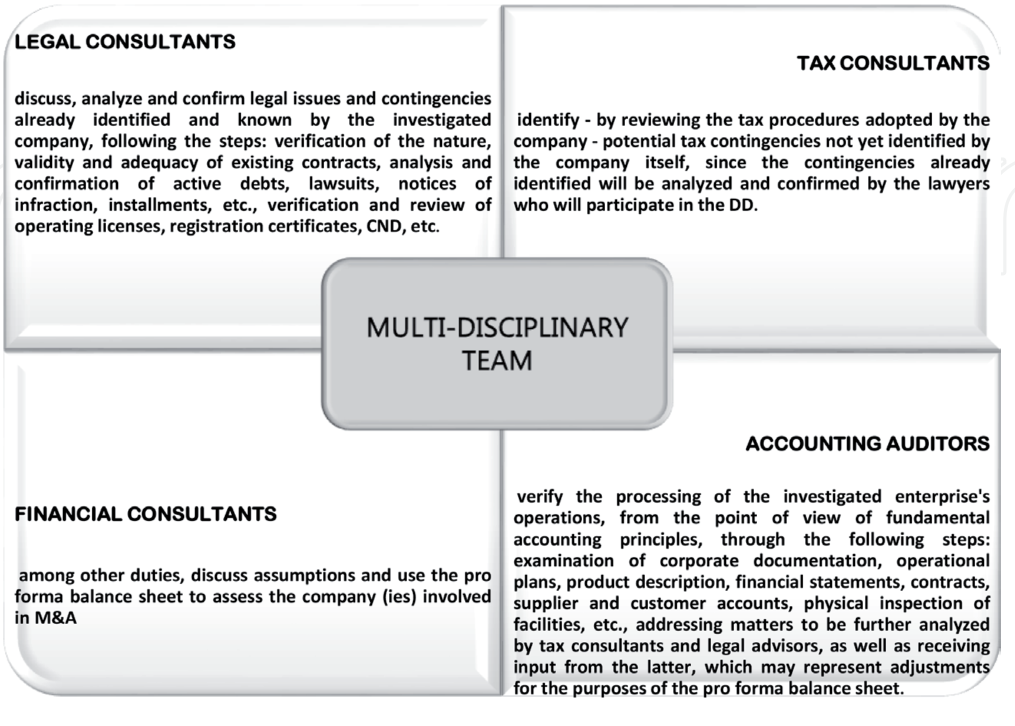

Figure 5.
Multidisciplinary team of specialists. Source prepared by the author.

Speaking specifically of the due diligence work in the tax area, it can be said that the primary objective of tax consultants will be to identify - through the review of the tax procedures adopted by the company under review (compliance) - potential tax contingencies not yet identified by the company itself, since the contingencies already effectively identified will be analyzed and confirmed by the lawyers who will participate in the due diligence process [37].

The main role of legal advisors will be to discuss, analyze and confirm judicial issues and contingencies already effectively identified and known by the company investigated. They must comply, among others, with the following steps: verification of the nature, validity and adequacy of existing contracts, analysis and confirmation of active debts, lawsuits, infringement notices, installments, etc., verification and review of operating licenses, registration certificates, tax authority negative certificates, etc. [38].

3.3 Areas to be examined

The multidisciplinary team will examine from the various angles of observation that their academic background and professional experience allow to evaluate, the following aspects of the target company, among others, as **Figure 6** displays:

3.3.1 Corporate aspects

Counsel for the buyer will invariably undertake a careful review of the organizational documents and general corporate records of the target company, including (among others): charter documents (certificate of incorporation, bylaws, etc.), good standing and (if applicable) tax authority certificates, list of subsidiaries and their respective charter documents, list of jurisdictions in which the company and its subsidiaries are qualified to do business, stockholder and voting agreements, minutes of stockholders' meetings since inception, including written consents to action without a meeting and minutes of board of directors and any board committees since inception, including written consents to action without a meeting [39].

Figure 6.
Areas of the target company to be examined. Source prepared by the author.

3.3.2 Contractual relations

It refers to the examination of contracts signed by the company, which have their execution in progress, with emphasis on financial and operational contracts, with a view to identifying possible default clauses in the event of disposal of controlling interest or other clauses that may affect the business. Legal proceedings involving the discussion of contracts should also be analyzed, with a view to identifying and quantifying possible contingencies [40].

The buyer will be concerned with all the target company's historical financial statements and related financial metrics, as well as the reasonableness of the target's projections of its future performance. One of the most time-consuming (but critical) components of a due diligence inquiry is the review of all material contracts and commitments of the target company. The categories of contracts that are important to review and understand include the following: guaranties, loans, and credit agreements, customer and supplier contracts, agreements imposing any restriction on the right or ability of the company (or a buyer) to compete in any line of business or in any geographic region with any other person, equity finance agreements and non-competition agreements [41].

3.3.3 Property

A review of all property owned by the target company or otherwise used in the business is an essential part of any due diligence investigation, with such review including deeds, leases of real property, deeds of trust and mortgages, title reports, other interests in real property, financing leases and sale and leaseback agreements, conditional sale agreements and operating leases [42].

This is the assessment of the documentary regularity of the main assets and the possible costs for the correction of irregularities found. Identification of the burden and encumbrances (mortgages, penhoras, servitudes, disposals, etc.) that fall on the properties. Supporting documents of the ownership of the main movable property should be analyzed to identify contingencies, burdens and encumbrances that may fall on them [43].

3.3.4 Environmental issues

Environmental due diligence is the other common workstream in a typical due diligence approach and focus on exposure in this area, as well as potential changes in run rate costs post-acquisition [44]. The buyer will want to analyze any potential environmental issues the target company may face, the scope of which will depend on the nature of its business [45].

The situation of environmental permits required for the exercise of the activity of the target undertaking should be examined. It is also necessary to analyze the judicial and administrative proceedings, to identify possible responsibilities for the repair of damage caused by it to the environment, as well as the regularity of the practices adopted in the context of its operations [46].

3.3.5 Consumer right

It is necessary to verify the situation of the relations maintained by the company with its consumers and with the consumer protection agencies. The existing cases against the company, whether in the administrative or judicial sphere, should also be analyzed to establish contingencies and the effects arising from possible irregular practice [47].

3.3.6 Labor aspects

Human resources due diligence typically includes a detailed review of the company's relationships with its employees, such as union agreements, regular benefits, executive compensation, and post-employment obligations. In addition to flushing out exposures, it can help identify cost structure changes that can occur if the target's employees join the buyer's benefit plans post-acquisition [48].

It refers to the evaluation of administrative and judicial processes, their routines adopted to identify possible contingencies and possible problems that may arise from the changes arising due to the proposed operation [49].

3.3.7 Tax and social security aspects

Tax due diligence may or may not be critical, depending on the historical operations of the target company, but even for companies that have not incurred historical income tax liabilities, an understanding of any tax carryforwards and their potential benefit to the buyer may be important [50].

This is the analysis of administrative and judicial processes, their tax and social security routines, to verify any problems, and those that may arise from the changes made with the implementation of the business [51].

Thus, in addition to the legal aspects, financial, strategic, technical, operational issues are analyzed, among others, so that, at the end of the entire analysis, a report is prepared that reflects the combination of the results found in all these different matters [52].

3.4 The pro forma balance sheet

After the completion of the exams by the multidisciplinary team engaged in the due diligence work, it is necessary to propose the appropriate adjustments in order to arrive a pro forma balance sheet, which will serve as the basis for financial projections (which will feed the business plan), the negotiation of the acquisition price, as well as the establishment of guarantees and escrow-account (in the case of acquisition), or for the determination of the exchange of shares (in the case of merger). A pro forma balance sheet is a financial document that discloses a business's assets, liabilities, and equity at a specific point in time. This financial statement is not prepared in accordance with Generally Accepted Accounting Standards (GAAP). It is considered more of a balance sheet projection [53].

3.5 The report

Due diligence work usually results in the preparation of a report, the form of which may vary depending on the interests of its recipient. Should the report describe the contingencies found, including, where possible, an estimate of theirs.

A due diligence report is the final report of the review conducted by the company in which the summary of the research done by the company is included [54].

Among the main objectives of due diligence are the identification of the main characteristics of the company; identification of possible obstacles to the conduct of the business and the quantification of existing contingencies; risk assessment; assistance in setting the price of the business; and assistance in the negotiation of contractual clauses [55].

Due diligence report is one of the most important records of conducting due diligence as it will be the final report that you will send to members of the executive team who will evaluate it. Without proper due diligence reporting, all the effort that you have put in conducting the due diligence will go astray [56].

It is necessary to highlight the agreed upon procedures scope used in the evaluation of the analyzed information, since the content of the report involves the evaluation of possible future effects of the situations, in fact, found, which rarely allows absolutely accurate estimates [57].

The agreed upon procedures scope differs from that of an annual audit [58]. A due diligence inspection must be quite separate from the annual audit because it is less profound [59].

Agreed upon procedures engagement is a type of engagement which auditor performs certain procedures that are agreed upon in advance. In this engagement, the auditor and specified parties agree that the auditor will perform specific procedures and report the findings. Likewise, there are usually three parties involved in the engagement, including the auditor, the client, and another third party. Unlike an audit, auditors do not give an opinion on subject matters in the agreed upon procedures. Auditors only report of findings based on the agreed procedures performed on the subject matter. Hence, the clients need to make their own conclusion on the subject matter [60].

Often, the interested party ends up assuming the risks of a limitation of scope due to its budget constraints or even the obligation to comply with time limits – an important fact, because due diligence is a time-consuming procedure, although it must be subject to the imposition of relatively short deadlines. Due diligence is also expensive for the party that must bear its costs, which increase in proportion to the size of the business and the number of problems found in it [61].

3.6 The sizing of the guarantees

The report shall indicate what guarantees would be required in the final contract to be signed between the parties. Thus, contingencies that are not quantifiable can be subject to specific guarantees, with a view to specifying value references to them, to be subject to subsequent adjustments, if they prove to be inaccurate. Those quantifiable can be directly deducted from the price, or in the event of uncertain occurrence, may be the subject of escrow accounts – a kind of deposit account, administered by a third party, whose values are released in the circumstances that the parties agreed to [62].

Where the purchaser determines that the seller is unlikely to have the resources to meet potential liability claims in connection with the transaction, the purchaser may seek the ability to hold-back (or escrow) a portion of the purchase price until the indemnity period (or as is more likely the case, a portion of the indemnity period) has expired [63].

Escrows are another common feature of transaction document, both the amount and duration of which can be increased as necessary to provide protection. Sometimes potential exposures can be so significant or clear as to the outcome if the target is audited that escrows will not provide a sufficient remedy. In these circumstances, alternate transaction structures, purchase price reductions, installment sales, and earn outs can all provide effective protection to a buyer.

The earn out clauses are defined by the parties and are detailed in the final contract. The payment method is detailed, and the use of escrow account can be established to ensure that if the earn out mechanisms are triggered, the buyer will obtain the adjustment in the amount to be paid [64].

Alternatively, when none of these remedies are sufficient, desirable, or obtainable (due to seller objections), buyers can consider purchasing tax risk insurance [65].

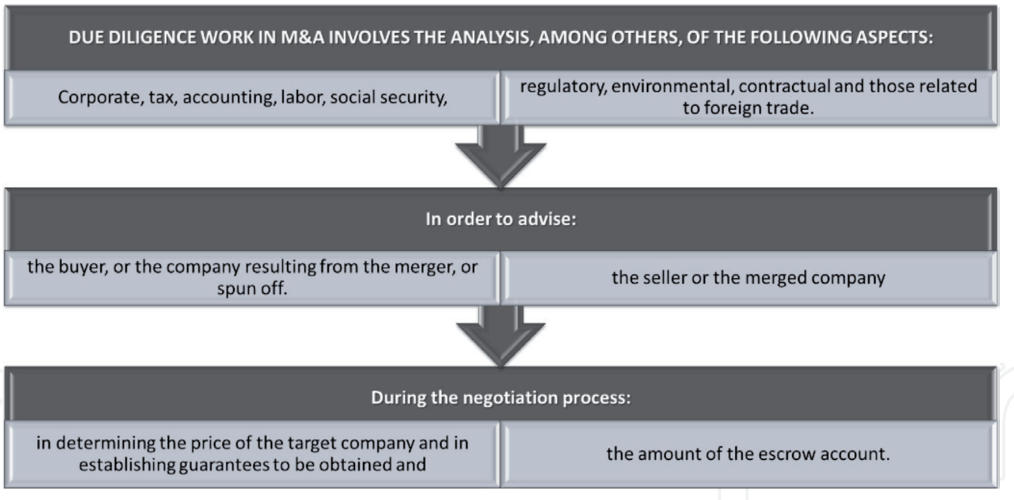

Figure 7.
Due diligence process flow. Source prepared by the author.

Thus, we can summarize the due diligence process through the flow shown in **Figure 7** above.

4. The main aspects of due diligence in the tax area

In today's corporate environment, acquisition transactions often occur on an aggressive time schedule or not at all. In addition, tax practitioners are often not consulted with respect to the tax sensitive aspects of the transaction until the final stages of the transaction, i.e., at the closing. For these reasons, familiarity with the basic tax framework for analyzing acquisition documents is essential [66].

Tax due diligence has its own importance, for two reasons. Firstly, tax risks often present significant hindrances for transactions [67]. Uncovering tax risks must be of special interest to the management of the corporation. Secondly, contrary to other fields of due diligence, tax law is subject to frequent, dynamical changes and puts rather complex demands on the inspection. It may not only have to deal with significantly different past, current and future tax regimes, but, in the case of international concern structures, it also must take the tax requirements of other countries into account. Therefore, efficient inspecting and auditing is of paramount importance in the tax arena.

Tax is one of the most important components that determine the overall profitability of a company. It is so important that it has its own place in the company's financial report in the name of items such as net profit before tax, net profit after tax, deferred tax, etc. Therefore, it goes without saying that the tax aspect cannot be overlooked in the due diligence during mergers and acquisitions [68].

Specifically, regarding the aspects to be observed in a due diligence work in the tax area, to be conducted by tax consultants, we could highlight the following.

4.1 Measurement of liabilities and assets accounted for

This is the due diligence of a research work, whereby the procedures and strategies of the tax area of the company under examination are evaluated, to verify whether the assets and tax liabilities accounted for are properly measured or if they are undervalued or overvalued [69].

4.2 Identification of unaccounted assets and liabilities

It seeks due diligence, also, to identify and measure unaccounted liabilities (hidden liabilities). Although it is not the main object of the work, attention should be paid to the possibility of identifying possible unaccounted or recognized tax assets that may be relevant to the negotiation process [70].

4.3 Disclosure of contingencies not quantified

Due diligence should report all tax procedures and strategies adopted by the company under investigation that may result in contingencies, but which, for various reasons (usually, lack of information and data), could not be quantified [71].

5. Conclusion

In view of the foregoing, it can be noted that the accounting, tax and legal due diligence consists of a work of investigation and analysis of the procedures, practices and strategies of the company under examination in several areas, carried out within the scope and materiality agreed upon procedures, in order to determine whether the assets and liabilities were properly recognized, the degree of realization of these assets, the degree of risk of these liabilities, as well as identifying the existence of other unrecognized liabilities or unidentified assets, thus providing the company that is demanding due diligence, with the elements necessary for a correct pricing, negotiation and overall assessment of the merger or acquisition operation [72].

The tax review essentially begins with the following question: “Has the seller paid all its tax liabilities on a current basis, and has a reasonable reserve been accrued for known and anticipated adjustments likely to arise in current and future audits by various taxing authorities?” Although the procedures used to examine these questions will vary depending on the size of the deal and the complexity of the target’s particular tax situation, these inquiries will generally entail a review and analysis of tax returns for all open years with special emphasis on the reconciliation between financial statement and taxable income and analysis of book and tax basis balance sheets, together with a review of the most recent revenue agent’s reports made by relevant taxing authorities [73].

Once completed, these results are then compared to reserves for taxes, or the so-called “cushion”, to determine whether the seller has adequately provided for any tax exposures. When representing financial buyers, another analysis that will often need to be done is a determination of when contingent tax liabilities may become due and payable. This obviously can tie into determining whether the buyer’s cash flow projections with respect to the target are correct [74].

Succession to the seller’s tax attributes is also an important area to review. Many companies today have net operating loss carryforwards and unutilized investment tax, foreign tax, and other credits. Depending on the type of acquisition structure, these tax attributes can represent significant cash savings to the buyer after the acquisition [75].

In view of all the exposed in this chapter, it remains clear the importance of the tax due diligence of the target company, as a way to minimize risks in the decision-making process of the managers of the purchasing company that may compromise the success of the merger and acquisition operation, as well as subjecting them to administrative and judicial processes, for non-compliance with their fiduciary duties of diligence and loyalty in relation to the company of which they are executives.

Additionally, the study's results suggest that companies—in compliance with the guidelines and limits set by the board—choose the appropriate and specific techniques of risk management, especially those related to minimization, immunization, and transferring these risks. The recommendations derive from the need to identify and manage tax risks, from the point of view of good corporate governance practices.

This study may serve as a reference to companies in general, when studying, developing, and implementing recommendations for the identification and minimization of tax risks, as well as in the development of a work program that allows them to conduct due diligence work in target companies.

Author details

Arnaldo Marques de Oliveira Neto
Fundação Getulio Vargas, São Paulo, Brazil

*Address all correspondence to: amarques@fgvmail.br

References

[1] De Oliveira Neto AM. Governança tributária e sustentabilidade. Revista Brasileira de Administração, n. 316, p 34. Conselho Federal de Administração, São Paulo; 2012.

[2] De Oliveira Neto, AM. Governance and risk management in taxation. Ed. Springer Science + Business Media, Singapore; 2017. 171 p. DOI: 10.1007/978-981-10-2297-5.

[3] Tributação na sociedade de risco. Revista Ciências Sociais, Rio de Janeiro, vol. 12, n. 1, pp 211-254 [Internet]; 2009. Available from: www.ugf.br/files/editais/Artigo%209%20Vol%2012%20n%201%20e%202.pdf [Accessed 1 Dec 2012].

[4] Paxson D, Wood D. The Blackwell Encyclopedic Dictionary of Finance, Oxford, United Kingdom; Blackwell Publishers, 1997. 240 p. ISBN10 155786912X and ISBN13 9781557869128.

[5] IBGC—Instituto Brasileiro De Governança Corporativa. Guia de orientação para gerenciamento de riscos corporativos. (Série cadernos de governança corporativa, n. 3). IBGC, São Paulo; 2007. 48 p. ISBN: 978-85-99645-04-8.

[6] Bernstein, PL. Desafio aos deuses: a fascinante história do risco, 3rd. Ed. Campos, Rio de Janeiro; 1996. 402 p.

[7] Beuren IM (Org.). Como elaborar trabalhos monográficos em contabilidade – 3. ed. São Paulo: Ed. Atlas, 2012. 195 p. ISBN: 978-85-224-4391-8.

[8] De Oliveira Neto, AM. Governance and risk management in taxation. Ed. Springer Science + Business Media, Singapore; 2017. 171 p. DOI: 10.1007/978-981-10-2297-5.

[9] Assi, M. Gestão de Riscos com controles internos. São Paulo: Ed. Saint Paul, 2012. 165 p. ISBN: 978-85-8004-050-0.

[10] De Oliveira Neto, AM. Governance and risk management in taxation. Ed. Springer Science + Business Media, Singapore; 2017. 171 p. DOI: 10.1007/978-981-10-2297-5.

[11] De Oliveira Neto AM. Relacionamento com os acionistas. In: Rocha T e Goldschmidt A, coordinators. Gestão dos stakeholders. Ed. Saraiva; 2011. p. 53-80. ISBN 978-85-02-10263-7.

[12] De Oliveira Neto AM. Relacionamento com os acionistas. In: Rocha T e Goldschmidt A, coordinators. Gestão dos stakeholders. Ed. Saraiva; 2011. p. 53-80. ISBN 978-85-02-10263-7.

[13] De Oliveira Neto, AM. Governance and risk management in taxation. Ed. Springer Science + Business Media, Singapore; 2017. 171 p. DOI: 10.1007/978-981-10-2297-5.

[14] De Oliveira Neto, AM. Governance and risk management in taxation. Ed. Springer Science + Business Media, Singapore; 2017. 171 p. DOI: 10.1007/978-981-10-2297-5.

[15] De Oliveira Neto AM. Governança tributária e sustentabilidade. Revista Brasileira de Administração, n. 316, p 34. Conselho Federal de Administração, São Paulo; 2012.

[16] Governança tributária: um estudo de caso sobre a importância e a viabilidade de implementação de suas práticas na empresa Alfa Ltda. 2011. 68f. Trabalho de Conclusão de Curso (Monografia)—Curso de Ciências Contábeis, Faculdade de Ciências Aplicadas, Petrolina [Internet]. Available from: (www.lapisletras.ba.gov.br/uploads/publicacoes/docs/governanca_tributariaLapis_e_Letras1339547364.pdf) [Accessed in 1 Dec 2012].

[17] Good corporate governance: the tax dimension—OECD forum on tax administration—July 2009 [Internet]. 2009. Available from: (http://www.oecd.org/tax/administration/43239887.pdf) [Accessed 22 May 2015].

[18] Erle B. Tax risk management and board responsibility. In: Drexl J, Hilty RM, Schön W, Straus J, editors. Tax and corporate governance. Ed. Springer, Berlin, Heidelberg; 2008. 423 p. DOI 10.1007/978-3-540-77276-7.

[19] Erle B. Tax risk management and board responsibility. In: Drexl J, Hilty RM, Schön W, Straus J, editors. Tax and corporate governance. Ed. Springer, Berlin, Heidelberg; 2008. 423 p. DOI 10.1007/978-3-540-77276-7.

[20] IBGC—Instituto Brasileiro de Governança Corporativa. Código de melhores práticas de governança corporativa. IBGC, São Paulo; 2009. 73 p. ISBN 978-85-99645-14-7.

[21] Governança empresarial, riscos e controles internos: a emergência de um novo modelo de controladoria. Revista Contabilidade e Finanças, São Paulo, v. 15, n. 34, Jan–Apr 2004 [Internet]. 2004. Available from: (www.scielo.br/phpw?pid=S1519-70772004000100001escript=sci_arttext) [Accessed in 1 Dec 2012].

[22] Erle B. Tax risk management and board responsibility. In: Drexl J, Hilty RM, Schön W, Straus J, editors. Tax and corporate governance. Ed. Springer, Berlin, Heidelberg; 2008. 423 p. DOI 10.1007/978-3-540-77276-7.

[23] De Oliveira Neto, AM. Governance and risk management in taxation. Ed. Springer Science + Business Media, Singapore; 2017. 171 p. DOI: 10.1007/978-981-10-2297-5.

[24] IBGC—Instituto Brasileiro De Governança Corporativa. Uma década de governança corporativa – Histórias do IBGC, marcos e lições de experiência. Ed. Saraiva, São Paulo; 2006. 224 p. ISBN 9788598838144.

[25] Handout "Corporate Governance" by Prof. Rubens Mazzali, p. 4 and 5, Dec/2016.

[26] Wald A, Moraes LR de, Waisberg I. Fusões, incorporações e aquisições – aspectos societários, contratuais e regulatórios. In Warde Jr WJ, coordinators. Fusão, cisão, incorporação e temas correlatos. Ed. Quartier Latin, São Paulo; 2009. p 29-76. ISBN 85-7674-391-4.

[27] De Oliveira Neto AM. Reponsabilidade tributária dos Sucessores. Revista Informe Performance, n. 50, p.6. Grupo Performance Alliot Brasil, Salvador; 2003.

[28] Gröger, H (2010) Planungsaspekte aus Erwerbersicht. In Kneip, Chr., Jänisch, Chr., editors, Tax Due Diligence. Steuerrisiken und Steuergestaltungen beim Unternehmenskauf. 2. Edition. München; 2010. p 545-558. ISBN 9783406597640.

[29] De Oliveira Neto AM. A importância do due diligence nos processos de fusão e de aquisição (merger and acquisition). Revista Informe Performance, n. 49, p.4 and 5. Grupo Performance Alliot Brasil, Salvador; 2003.

[30] Improving the acquisition profit of cross border transactions by adjusting the tax due diligence process – a theoretical model based on a german target. Periodica Polytechnica Social and Management Sciences, pp. 41-50 [Internet]. 2015. Available from: (https://www.researchgate.net/publication/277568541_Improving_the_Aquisition_Profit_of_Cross_Border_Transactions_by_Adjusting_the_Tax_Due_Diligence_Process_-_a_Theoretical_Model_Based_on_a_

German_Target) [Accessed 25 November 2019].

[31] Rossi, LEM. Manual de private equity e venture capital: passos para a atração de investidores e alocação de recursos. Ed. Atlas, São Paulo; 2010. 235 p. ISBN 978-85-224-5969-8.

[32] Improving the acquisition profit of cross border transactions by adjusting the tax due diligence process – a theoretical model based on a german target. Periodica Polytechnica Social and Management Sciences, pp. 41-50 [Internet]. 2015. Available from: (https://www.researchgate.net/publication/277568541_Improving_the_Aquisition_Profit_of_Cross_Border_Transactions_by_Adjusting_the_Tax_Due_Diligence_Process_-_a_Theoretical_Model_Based_on_a_German_Target) [Accessed 25 November 2019].

[33] Nejm E e Bruna SV (2002). Due diligence – identificando contingências para prever riscos futuros. In Saddi J, organizer. Fusões e aquisições: aspectos jurídicos e econômicos. Ed. IOB, São Paulo; 2002. p 203-219. CDD-338.83.

[34] Nejm E e Bruna SV (2002). Due diligence – identificando contingências para prever riscos futuros. In Saddi J, organizer. Fusões e aquisições: aspectos jurídicos e econômicos. Ed. IOB, São Paulo; 2002. p 203-219. CDD-338.83.

[35] De Oliveira Neto AM. A importância do due diligence nos processos de fusão e de aquisição (merger and acquisition). Revista Informe Performance, n. 49, p.4 and 5. Grupo Performance Alliot Brasil, Salvador; 2003.

[36] De Oliveira Neto AM. A importância do due diligence nos processos de fusão e de aquisição (merger and acquisition). Revista Informe Performance, n. 49, p.4 and 5. Grupo Performance Alliot Brasil, Salvador; 2003.

[37] Accounting Due Diligence Checklist [Internet]. 2020. Available from: (https://yourbusiness.azcentral.com/prepare-memo-revenue-cycle-problems-27943.html) [Accessed 3 February 2021].

[38] The Scope of Due Diligence in Mergers and Acquisitions [Internet]. 2017. Available from: (https://capitalorigination.net/insights/entry/the-scope-of-due-diligence-in-mergers-and-acquisitions) [Accessed 3 February 2021].

[39] 20 key due diligence activities in a merger and acquisition transaction [Internet]. 2014. Available from: (https://www.forbes.com/sites/allbusiness/2014/12/19/20-key-due-diligence-activities-in-a-merger-and-acquisition-transaction/?sh=70e2442f4bfc) [Accessed 11 November 2020].

[40] Nejm E e Bruna SV (2002). Due diligence – identificando contingências para prever riscos futuros. In Saddi J, organizer. Fusões e aquisições: aspectos jurídicos e econômicos. Ed. IOB, São Paulo; 2002. p 203-219. CDD-338.83.

[41] 20 key due diligence activities in a merger and acquisition transaction [Internet]. 2014. Available from: (https://www.forbes.com/sites/allbusiness/2014/12/19/20-key-due-diligence-activities-in-a-merger-and-acquisition-transaction/?sh=70e2442f4bfc) [Accessed 11 November 2020].

[42] 20 key due diligence activities in a merger and acquisition transaction [Internet]. 2014. Available from: (https://www.forbes.com/sites/allbusiness/2014/12/19/20-key-due-diligence-activities-in-a-merger-and-acquisition-transaction/?sh=70e2442f4bfc) [Accessed 11 November 2020].

[43] Nejm E e Bruna SV (2002). Due diligence – identificando contingências para prever riscos futuros. In Saddi J, organizer. Fusões e aquisições: aspectos jurídicos e econômicos. Ed. IOB, São Paulo; 2002. p 203-219. CDD-338.83.

[44] Due diligence [Internet]. 2020. Available from: (https://www.bestarcorporation.com/post/due-diligence) [Accessed 11 November 2020].

[45] 20 key due diligence activities in a merger and acquisition transaction [Internet]. 2014. Available from: (https://www.forbes.com/sites/allbusiness/2014/12/19/20-key-due-diligence-activities-in-a-merger-and-acquisition-transaction/?sh=70e2442f4bfc) [Accessed 11 November 2020].

[46] Nejm E e Bruna SV (2002). Due diligence – identificando contingências para prever riscos futuros. In Saddi J, organizer. Fusões e aquisições: aspectos jurídicos e econômicos. Ed. IOB, São Paulo; 2002. p 203-219. CDD-338.83.

[47] Nejm E e Bruna SV (2002). Due diligence – identificando contingências para prever riscos futuros. In Saddi J, organizer. Fusões e aquisições: aspectos jurídicos e econômicos. Ed. IOB, São Paulo; 2002. p 203-219. CDD-338.83.

[48] Due diligence [Internet]. 2020. Available from: (https://www.bestarcorporation.com/post/due-diligence) [Accessed 11 November 2020].

[49] Nejm E e Bruna SV (2002). Due diligence – identificando contingências para prever riscos futuros. In Saddi J, organizer. Fusões e aquisições: aspectos jurídicos e econômicos. Ed. IOB, São Paulo; 2002. p 203-219. CDD-338.83.

[50] 20 key due diligence activities in a merger and acquisition transaction [Internet]. 2014. Available from: (https://www.forbes.com/sites/allbusiness/2014/12/19/20-key-due-diligence-activities-in-a-merger-and-acquisition-transaction/?sh=70e2442f4bfc) [Accessed 11 November 2020].

[51] Nejm E e Bruna SV (2002). Due diligence – identificando contingências para prever riscos futuros. In Saddi J, organizer. Fusões e aquisições: aspectos jurídicos e econômicos. Ed. IOB, São Paulo; 2002. p 203-219. CDD-338.83.

[52] Wald A, Moraes LR de, Waisberg I. Fusões, incorporações e aquisições – aspectos societários, contratuais e regulatórios. In Warde Jr WJ, coordinators. Fusão, cisão, incorporação e temas correlatos. Ed. Quartier Latin, São Paulo; 2009. p 29-76. ISBN 85-7674-391-4.

[53] What is a pro forma balance sheet? [Internet]. 2021. Available from: (https://www.wisegeek.com/what-is-a-pro forma-balance-sheet.htm) [Accessed 3 February 2021].

[54] Nejm E e Bruna SV (2002). Due diligence – identificando contingências para prever riscos futuros. In Saddi J, organizer. Fusões e aquisições: aspectos jurídicos e econômicos. Ed. IOB, São Paulo; 2002. p 203-219. CDD-338.83.

[55] Wald A, Moraes LR de, Waisberg I. Fusões, incorporações e aquisições – aspectos societários, contratuais e regulatórios. In Warde Jr WJ, coordinators. Fusão, cisão, incorporação e temas correlatos. Ed. Quartier Latin, São Paulo; 2009. p 29-76. ISBN 85-7674-391-4.

[56] How to write a due diligence report and what to include in it [Internet]. 2009. Available from: (https://www.darbaar.com/how-to-write-due-diligence-report/) [Accessed 11 November 2020].

[57] De Oliveira Neto AM. A importância do due diligence nos processos de fusão e de aquisição (merger and acquisition). Revista Informe Performance, n. 49, p.4 and 5. Grupo Performance Alliot Brasil, Salvador; 2003.

[58] Lück W (2000). Quality Control. Maßnahmen zur Qualitätssicherung in der Wirtschaftsprüfer-Praxis. Der Betrieb. 53; 2000. p 1-6. ISBN 3-486-27513-5.

[59] Hogh M. Due Diligence und Unternehmenskauf. In: Kneip, Chr., Jänisch, Chr., editors, Tax Due Diligence. Steuerrisiken und Steuergestaltungen beim Unternehmenskauf, 2. Edition. München; 2010a. p 1-7. ISBN 9783406597640.

[60] Agreed Upon Procedures [Internet]. 2020. Available from: (https://accountinguide.com/agreed upon-procedures/) [Accessed 3 February 2021].

[61] Wald A, Moraes LR de, Waisberg I. Fusões, incorporações e aquisições – aspectos societários, contratuais e regulatórios. In Warde Jr WJ, coordinators. Fusão, cisão, incorporação e temas correlatos. Ed. Quartier Latin, São Paulo; 2009. p 29-76. ISBN 85-7674-391-4.

[62] Nejm E e Bruna SV (2002). Due diligence – identificando contingências para prever riscos futuros. In Saddi J, organizer. Fusões e aquisições: aspectos jurídicos e econômicos. Ed. IOB, São Paulo; 2002. p 203-219. CDD-338.83.

[63] The tax due diligence process and negotiating and drafting tax provisions in acquisition agreements, pp. D-3, D-4 and D-32 [Internet]. 2000. Available from: (https://www.law.uh.edu/faculty/bwells/cit/duediligence.pdf) [Accessed 11 November 2020].

[64] Rossi, LEM. Manual de private equity e venture capital: passos para a atração de investidores e alocação de recursos. Ed. Atlas, São Paulo; 2010. 235 p. ISBN 978-85-224-5969-8.

[65] Tax due diligence: because what you do not know can hurt you [Internet]. 2019. Available from: (https://efinancemanagement.com/mergers-and-acquisitions/tax-due-diligence) [Accessed 11 November 2019].

[66] The tax due diligence process and negotiating and drafting tax provisions in acquisition agreements, pp. D-3, D-4 and D-32 [Internet]. 2000. Available from: (https://www.law.uh.edu/faculty/bwells/cit/duediligence.pdf) [Accessed 11 November 2020].

[67] Gerber, Chr, König, J (2009) Controlling steuerlicher Risiken in M&A Transaktionen. Controlling & Management. 53 (1); 2009. p 59-63.

[68] Tax due diligence [Internet]. 2019. Available from: (https://efinancemanagement.com/mergers-and-acquisitions/tax-due-diligence) [Accessed 11 November 2019].

[69] De Oliveira Neto AM. A importância do due diligence nos processos de fusão e de aquisição (merger and acquisition). Revista Informe Performance, n. 49, p.4 and 5. Grupo Performance Alliot Brasil, Salvador; 2003.

[70] De Oliveira Neto AM. A importância do due diligence nos processos de fusão e de aquisição (merger and acquisition). Revista Informe Performance, n. 49, p.4 and 5. Grupo Performance Alliot Brasil, Salvador; 2003.

[71] De Oliveira Neto AM. A importância do due diligence nos processos de fusão e de aquisição (merger and acquisition). Revista Informe Performance, n. 49, p.4 and 5. Grupo Performance Alliot Brasil, Salvador; 2003.

[72] De Oliveira Neto AM. A importância do due diligence nos processos de fusão e de aquisição (merger and acquisition). Revista Informe Performance, n. 49, p.4 and 5. Grupo Performance Alliot Brasil, Salvador; 2003.

[73] The tax due diligence process and negotiating and drafting tax provisions in acquisition agreements, pp. D-3, D-4 and D-32 [Internet]. 2000. Available from: (https://www.law.uh.edu/faculty/bwells/cit/duediligence.pdf) [Accessed 11 November 2020].

[74] The tax due diligence process and negotiating and drafting tax provisions in acquisition agreements, pp. D-3, D-4 and D-32 [Internet]. 2000. Available from: (https://www.law.uh.edu/faculty/bwells/cit/duediligence.pdf) [Accessed 11 November 2020].

[75] The tax due diligence process and negotiating and drafting tax provisions in acquisition agreements, pp. D-3, D-4 and D-32 [Internet]. 2000. Available from: (https://www.law.uh.edu/faculty/bwells/cit/duediligence.pdf) [Accessed 11 November 2020].