



TMI Eyes No. 21: Contract Drafting and Tax Implications

Contracts are essential documents for business operators, enabling them to execute and manage their business activities effectively. It is important to note that different types of contracts can have varying tax implications, which businesses should understand to optimize their tax efficiency.

In this article, TMI will discuss key aspects of contract drafting and tax implications below.

Contracts and Taxation

Under Thai law, contracts are legally binding agreements between two or more parties that establish their rights and obligations for various purposes, such as the sale of goods, provision of services, granting rights to use intellectual properties, lease agreements, loans, and more.

The correlation between contracts and taxation lies in the fact that the type, terms, and conditions specified in contracts directly determine their types of income and tax implications. For example, the Revenue Code classifies income into eight categories under Section 40(1)-(8): income from employment, hire-of-work (service), royalties, income from capital, lease income, professional services, services requiring high investment, and other commercial income.

It is essential to understand that the classification of income under Section 40 is based on both the form of the agreement and the substance of the transaction. Correctly identifying the type of income is crucial, as each type can have different tax implications, including withholding tax, stamp duty, recognition/realization of income, deductible expenses, filing requirements for specific tax returns, etc. Additionally, the type of contract and income classification can affect Value Added Tax (VAT) and Specific Business Tax (SBT) obligations.

Contract Drafting in the Aspect of Taxation

When drafting contracts, businesses should consider the following steps to align with tax considerations:

1. Understand Ordinary Business Operations
2. Thoroughly Understand the Transaction.
3. Distinguish Types of Contracts
4. Choose Appropriate Titles, Terms, and Conditions
5. Use precise and legally sound language to specify rights, obligations, remuneration, and other relevant details.

6. Consider combining or dividing agreements where there are multiple contract elements in a transaction.

Examples:

Sale/Purchase vs. Service

A purchase contract involves a seller agreeing to transfer ownership of goods to a buyer, while a service (hire-of-work) agreement requires contractors to complete specific work for an employer. A sale/purchase agreement is not subject to withholding tax or stamp duty, whereas a service agreement is subject to both taxes.

A common issue arises when a party manufactures products using raw materials, designs, and know-how provided by another party. In such cases, the manufacturer may view the transaction as a sale of goods; however, based on these functions, the Revenue Department often classifies it as a service agreement.

Service vs. Royalties

When payments are made to a foreign provider, most service fees are treated as business profits under double taxation agreements to which Thailand is a signatory, while royalties are generally subject to withholding tax. The key distinction lies in the nature of the transaction: service fees involve the provision of general services, whereas royalties pertain to the transfer of intellectual property or know-how. A correct determination will help the payer of the income make correct withholding tax treatment.

Combine vs. Separate Contracts

When multiple types of transactions are included in the same agreement, the tax implications may vary. For instance, if a lease and a service are combined in one agreement with a single fee (or even separate fees), the Revenue Department is likely to treat the entire fee as a service fee. It is important to note that services are generally subject to a 3% withholding tax and 7% VAT, whereas the lease of immovable property is subject to a 5% withholding tax without VAT.

TMI's Final Note

By carefully considering these aspects during contract drafting, readers can ensure that the contract accurately reflects the parties' intentions, clearly classifies the type of contract to avoid ambiguities that could lead to incorrect tax treatment and structures the terms to achieve the desired tax outcomes. Readers also then ensure compliance with Thai tax laws and improve their overall tax efficiency.




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