

TMI Eyes No. 30: Contract Drafting and Tax Implications (Part 2)

In Part 1, we explored the foundational considerations for business operators when entering into contracts, including understanding the transaction's substance, identifying applicable taxes, and structuring agreements to optimize tax efficiency. We also highlighted common pitfalls, such as the misclassification of contract manufacturing or the tax implications of combined versus separate agreements.

In Part 2, we will continue to look at other critical contractual provisions that can significantly impact tax outcomes, including responsibilities for tax payments, intellectual property rights, gross-up mechanisms, and compliance with withholding tax rules. Additionally, we will discuss practical examples and lessons from real-world cases to help business operators draft agreements that are not only commercially sound but also fully compliant with tax laws.

By understanding these nuances, operators can reduce unexpected tax liabilities, manage risks effectively, and ensure that their agreements reflect both legal substance and tax-efficient structure.

1. Other Terms and Conditions

(a) Responsibility for Tax Payment

Agreements should clearly specify whether fees are to be paid net of tax or on a gross basis. If the contract requires the recipient to receive a net amount after withholding tax, the payer must "gross up" the payment to cover the tax cost. This results in higher overall expenses for the payer.

Example: Suppose a royalty payment of 100 is due to an offshore recipient, and the applicable withholding tax is 15%. If the agreement requires the recipient to receive a net 100 after tax, the payer must calculate the grossed-up amount:

$$100 \div (1 - 0.15) = 117.65$$

Here, the payer must pay 117.65, with 17.65 remitted as withholding tax, effectively increasing the cost by 17.65.

(b) Ownership of the Work

Another common issue arises when a service provider insists on retaining ownership of the work delivered under the agreement. While this may appear commercially acceptable, the

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tax consequence can be significant. If the Revenue Department determines that the substance of the contract is not a service but instead a grant of rights to use intellectual property, the payment may be recharacterized as a royalty. In such a case, the income would no longer qualify as business profits (potentially exempt from withholding tax under tax treaties) but instead become subject to a 15% withholding tax.

(c) Expenses Determined from Profits

Another common mistake observed among taxpayers is determining expenses based on the profits earned at the end of the accounting period. It is often seen that taxpayers calculate service fees based on the company's profits. Under Section 65(19), companies making such payments are not allowed to deduct these expenses for corporate income tax purposes. Therefore, companies must exercise great caution when setting the terms for calculating service fees or other fees.

2. No Tax Evasion

Readers should always bear in mind that tax planning involves using existing legal provisions, and in some cases, carefully navigating ambiguities in the law, to structure transactions efficiently. Tax planning must never cross the line into tax evasion, which is illegal.

Examples of prohibited practices include entering into sham contracts, misrepresenting facts to avoid taxes (such as transferring funds abroad under the guise of profit repatriation), claiming management fees without providing actual services, or structuring agreements to treat royalties for intellectual property use as service fees to circumvent withholding tax obligations.

TMI's Note

In conclusion, careful attention to tax considerations when drafting agreements can significantly affect the overall cost, risk allocation, and efficiency of a transaction. Business operators should always ensure that the form of the contract reflects its true commercial substance, with clear terms on tax responsibilities, to prevent unintended liabilities. Proper structuring can help minimize unnecessary tax burdens while remaining fully compliant with the law. Importantly, tax planning in contract drafting should never be confused with tax evasion—the goal is not to avoid taxes unlawfully, but to manage transactions in a way that is transparent, defensible, and tax-efficient.

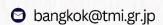
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