

# Constructive Dividends

## Thai Court's Recent Recognition of Constructive Dividends

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In the landmark Supreme Court judgment, finally the Thai Supreme Court explicitly recognizes Revenue Department's treatment of indirect payments to a shareholder as constructive dividend. This new Supreme Court precedent has implications on a transaction between companies with the same group of companies, either a multinational corporation or a local conglomerate (aka an intra-corporate transaction).

### 1. What is a constructive dividend?



First and foremost, nobody likes paying tax. Upon distributing a dividend payment to its shareholder, a dividend paying company knows that its shareholder in most jurisdictions is almost always liable for paying income tax (either corporate income or personal income tax as the case may be) to the tax

authority. But company's shareholder doesn't wish to foot that income tax bill outright. To avoid paying that income tax, the shareholder becomes creative and uses one's influence to get the company to take any other action(s) or enter into any other transaction(s) that ends up financially benefiting the shareholder without formally declaring and distributing the dividends.

Basically, if the company takes any action(s) or enters into any other transaction(s) (i.e. company's provision of services to the shareholder or company's payment of shareholder's personal expenses) to directly or indirectly pass the economic value to the shareholder, such action(s)/transaction(s) can result in the constructive dividend. Historically, in the United States the Internal Revenue Service began to make an assessment of this constructive dividend going back to the 1930s and the US court agreed to such assessment. But this concept is still relatively new in Thailand.

## **2. How does the Thai Revenue Code address a constructive dividend or even a constructive loan? Beyond this case, what is the constructive loan?**

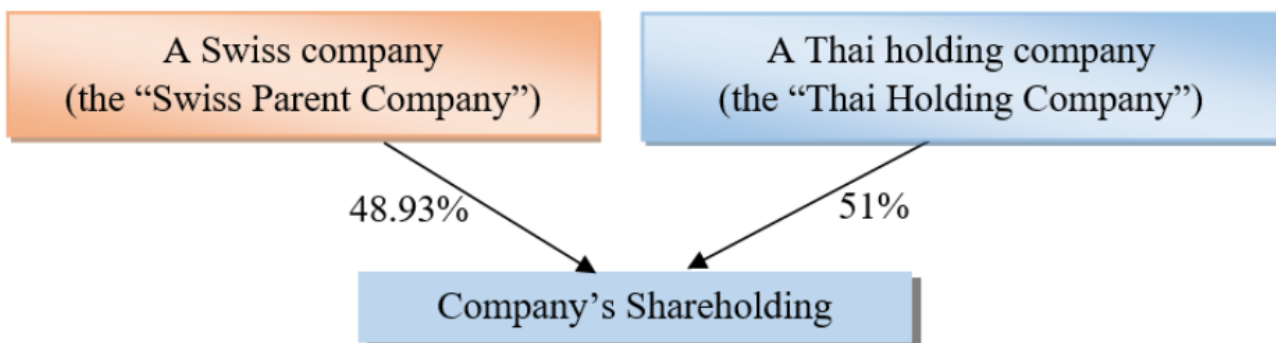
In Thailand, some assessment officials of the Revenue Department have begun to treat the value derived from a transaction between related companies in the same group of companies (aka an intra-corporate transaction) as a constructive dividend or even a constructive loan in some cases for quite some time despite the fact that the Revenue Code does not explicitly mention any constructive dividend or any constructive loan to begin with.

For instance, Company A, which is subject to 20% corporate income tax, might purposefully overpay Company B, which is exempt for corporate income tax due to either the BOI promotion or a loss carried forward, for goods or services by Baht 100. Having discovered this transaction, an assessment official will definitely disallow a portion that exceeds a market price (which is Baht 100 in this case) as a nondeductible expense of Company A in computation of Company A's net profit for a purpose of paying corporate income tax of Company A, and on a case by case basis (or occasionally depending on which assessment official is in charge) the assessment official may make another assessment of a constructive loan being granted to the Company B, which results in Company A's having to recognize an interest that is supposed to derive from that constructive loan as assessable income and pay corporate income tax and possibly specific business tax (if applicable).

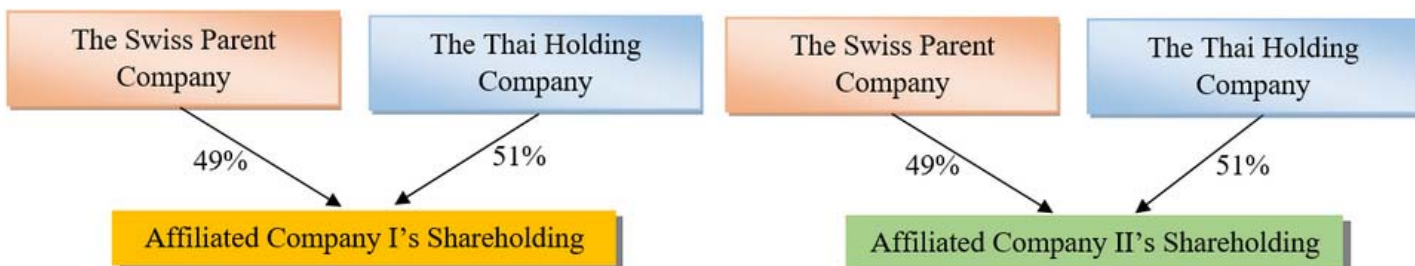
In light of Revenue Department’s interpretation of the constructive dividend or the constructive loan going back at least four to five years, the Thai Revenue Code is silent on this issue of either the constructive dividend or the constructive loan. This apparent lack of statutory clarity leaves a wide latitude of discretion to each responsible assessment official to construe the facts and the Revenue Code on a case by case basis. It is noteworthy that prior to this Supreme Court judgment, there was no Supreme Court precedent on how the Thai court might treat this constructive dividend.

### 3. What does the Supreme Court hold in this landmark case?

In this case, the Swiss owned company was a limited liability company incorporated under the Civil and Commercial Code in Thailand (the “Company”). The Company was about to be dissolved and commence its liquidation.



The Company has two affiliated companies in Thailand, Affiliated Company I and Affiliated Company II. Both Affiliated Company I and Affiliated Company II are also the limited liabilities companies incorporated under the Civil and Commercial Code in Thailand with the following shareholding.



Prior to registration of the dissolution with the Department of Business Development, the Company passed a resolution of the Board of Directors to grant the unconditional financial assistance of Baht 72 Million to Affiliated Company I and the unconditional financial assistance of Baht 27 Million to Affiliated Company II (Baht 99 Million in total). Both Affiliated Company I and Affiliated Company II used this money (Baht 99 Million) to partially pay off the debts that they still owed to the Swiss Parent Company. At the time, the Company was not jointly and severally liable with Affiliated Company I and Affiliated Company II to the Swiss Parent Company in any way. To add salt to injury, the Company did not seem to derive any economical/commercial benefit in return for providing such financial assistance to Affiliated Company I and Affiliated Company II at all.



An assessment official of the Revenue Department went ahead to treat 48.93% of total value of a series of these payments/transactions (48.93% of Baht 72 Million and 48.93% of Baht 27 Million respectively) as a constructive dividend made by the Company to the Swiss Parent Company, Company's 48.93% shareholder, on a ground that the Swiss Parent Company holds 48.93% of the total shares of the Company. As a result of this unfavorable recharacterization made by this assessment official, the assessment official deemed that the Company had to deduct withholding income tax at a rate of 10% of the value of the constructive dividend upon making the deemed payment of this constructive dividend to the Swiss Parent Company. Given the Company did not deduct any 10% withholding income tax at all, the assessment official made an assessment of 10% withholding tax on the constructive dividend and a surcharge. Needless to say the Company disagreed with assessment official's assessment and filed an appeal against this assessment to the Appellate Committee and eventually filed a lawsuit against the Revenue Department to the Central Tax Court. And eventually the case went all the way to the Supreme Court. In the end, the

Appellate Committee, the Central Tax Court and the Supreme Court all deemed that this assessment official's assessment was valid and lawful, effectively recognizing and establishing a concept of the constructive dividend under Thai law. The Supreme Court recognized that the Company essentially had made a payment of the constructive dividend to the Swiss Parent Company and that the Company had to deduct 10% withholding income tax on the deemed payment of this constructive dividend.

	Affiliated Company I	Affiliated Company II
Unconditional Financial Assistance	Baht 72,000,000	Baht 27,000,000
Constructive Dividend for the Swiss Parent Company as app. 48.93% Shareholder of the Company.	$72,000,000 \times 48.93\%$ = 35,227,600	$27,000,000 \times 48.93\%$ = 13,211,100
10% Withholding Income Tax on Constructive Dividend	$35,227,600 \times 10\%$ = 3,522,760	$13,211,100 \times 10\%$ = 1,321,110

#### 4. What is an implication of Supreme Court's interpretation in this case? And what can you do about it?



In light of this new development, going forward an assessment official will definitely have more latitude in treating certain transactions between companies in the same group of companies (aka intra-corporate transaction) as either a constructive dividend or a constructive loan. Any related

transaction between your company and your affiliated company must be done with extra care to ensure that there is always an economic justification for your transaction. Any intra-corporate transaction that does not make any commercial/economic sense should be ruled out or avoided because the chance is the Revenue Department will make an assessment not only from a transfer pricing point of view, but also from the constructive dividend/constructive loan perspective. At some point, it might be necessary to seek professional help. This caution should apply across the board (either a Thai conglomerate or multinational corporations).

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