ISSUES PERTAINING TO THE TAXATION OF FOREIGN INVESTORS IN INDONESIA*

Indonesia with its fertile soil and with its richness of minerals has always been the focus of interest of foreign investors. Before World War II foreign investors, particularly Dutch entrepreneurs, staked their capital in enterprises in Indonesia, such as rubber —, tea —, cinchone —, sugar cane plantations etc. as well as in international trade enterprises.

Shortly after the proclamation of independence in Indonesia, most of the foreign owned enterprises were taken over by the Government and became state owned enterprises. This caused many foreign investors to withhold capital investments in Indonesia. Although Indonesia never totally closed the door against foreign capital, the foreign capital curve showed a declining trend. Upon realisation that Indonesia still needed the inflow of foreign capital to develop the economic situation, the Indonesian Government now seeks to attract the interest of foreign investors. Since the foreign currency barrier has been abolished, significant possibilities have been opened for the free traffic of foreign exchange, more so after the promulgation of Government Regulation No. 16 of 1970, in which the Indonesian Government adopted a new policy in the field of import, export and foreign exchange.

The Law of Foreign Capital Investment, No. 78, promulgated in 1958 was the first legislation to promote foreign investments in Indonesia but it did not produce results meeting the expectations of the Government. The distrust of the left oriented government at that time, was the main reason for its lack of success. Besides, there was no guarantee that foreign capital would not be nationalized. The economic as well as political situation were far from stable.[1] Later this Act was revoked in 1963.[2] After the abortive Coup of the left parties, a new Government came into existence, consisting of broad minded, energetic and progressive leaders, what we call the New Order. In its effort to stabilize and rehabilitate the economy of Indonesia, the present Indonesian Government adopted an economic democracy as a logical consequence of its return to a politically democratic order. To demonstrate Indonesia's sincerity in inviting foreign capital investment, Indonesia

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1. See Rochmat Soemitro: Taxation and its functions as to create a favourable climate for private capital investments. Conference on Private Investments and International Transactions in Asian & South Pacific Countries, July 9-13, Singapore.

2. Law No. 16 Year 1963.

has resolved to return those foreign enterprises which were taken over by the Government to their former owners. In addition, a new law was promulgated[3] to encourage and to stimulate foreign capital investment in Indonesia.

It was felt that the development of the economic potential of Indonesia should be based on the capability and initiative of the Indonesian people themselves. Therefore foreign capital should participate only in projects where national capital is not available. Also foreign investments introducing advances in technology and management which Indonesia had not generated out of its own experience were welcomed. Indonesia's interest in encouraging foreign private investment arises from certain national policies and objectives. Foreign capital, technology and management can make enormous contributions to the economic and social development of Indonesia and those who furnish it are entitled to ample rewards.

Although foreign investors are assured of full authority to determine their own management personnel, they are generally required to meet their other man-power needs with Indonesian nationals. They are expressly authorized to assign foreign managerial and technical employees to positions for which qualified Indonesian nationals cannot yet be found.

To prevent misunderstanding in the discussion, I would like to define a "foreign investor" as a juridical entity as well as a physical person, irrespective of nationality, domiciled abroad, investing foreign capital in Indonesia, directly or indirectly. The investment could be administered in the frame of Foreign Capital Investment Law (Law No. 1 of 1967) or not.

Foreign capital is to be understood to cover foreign exchange which does not form a part of the foreign exchange resources of Indonesia, and which is utilized to finance an enterprise in Indonesia. This term is to be extended to new equipment for an undertaking, including rights to technological developments and materials imported into Indonesia which is not financed from Indonesian foreign exchange resources. It covers also profits permitted to be transferred abroad, but instead, are reinvested in Indonesia for special purposes. Foreign investors having their domicile in Indonesia are beyond the scope of this paper, because for tax purposes, they are treated as resident taxpayers.

For the sake of systematic discussion, we will make a distinction between:

1. foreign investors who invest their capital in an enterprise in Indonesia, *in the frame of Law No. 1 of 1967,* (Law of Foreign Capital Investment), and

2. foreign investors who invest their capital *not in the frame of Foreign Capital Investment.*

3. Law No. 1 Year 1967 S.G. 1967 No. 1, Supplementary State Gazette No. 2818; amended by Law No. 11 Year 1970 S.G. 1970 No. 46, Supplementary State Gazette No. 2943.

1. *Foreign Investors who invest their Capital in the frame of Foreign Capital Investment Law (F.C.I.L.).*

   a. Prerequisite of the F.C.I.L. is that the enterprise which is operated wholly or for the greater part in Indonesia, must be a legal entity organized under Indonesian Law and have its domicile in Indonesia;

   b. The Indonesian Government determines:
   - — the geographical area
   - — the field of activity
   - — the amount of capital to be invested
   - — the kind of enterprise

   which will be declared open for F.C.I.

Two problems will directly arise:

1.1. the taxation of the non-resident investor

1.2. the taxation of the enterprise carried on in Indonesia which forms a source of income for foreign investors.

1.1. The non-resident investor may invest his money in an F.C.I, enterprise in the form of:

1. shares or other participation which could be identified as a share, in which case the investor will receive dividends;

2. loans, in which case the investor will receive interest.

1.1.1. *The Taxation of Dividends*

Accrued profit, after subtraction of taxes and other obligations in Indonesia, may be transferred to the home country in the original currency. Distributed profits in whatever form or under whatever name, are liable to Indonesian Dividend Tax. This tax formally called, Tax on Interest, Dividend and Royalties, in short T.I.D.R., is a tax withheld at the source, at a flat rate of 20%.[4]

Dividends distributed by enterprises which carry on business in Indonesia in the frame of Foreign Capital Investment, are exempt from T.I.D.R. for a period of two years, counted from the moment the enterprise starts its commercial production, *provided that such dividend is exempt from income tax in the recipient's country.*[5] The two years tax exemption period may be extended with an additional tax free period, as provided in art. 16 para. 2, Act No. 11 of 1970.[6]

4. See Art. 1 Tax on Interest, Dividend and Royalty, Soemitro Suppl. IV p. 377 and appendix.

5. Art. 15 of Act No. 1 Year 1967, amended by Act No. 11 Year 1970 S.G. 1970 No. 45 Soemitro Suppl. IV p. 461, 477.

6. *Ibid.*, pp.477 and 478.

This conditionally granted exemption is to prevent a tax shifting from the country in which the dividend arises to the country of the recipient.

If the dividend received from an enterprise in Indonesia which carries on business in the frame of F.C.I., will be taxed in the country of the recipient, then this exemption provision will be waived. The ordinary provision of the T.I.D.R. will then be effective.

At this juncture we should mention the recently concluded Tax Agreement between the Republic of Indonesia and the Kingdom of the Netherlands for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on Income and Capital. This is the first international treaty concluded by Indonesia, but to my knowledge up to this moment, the agreement has not been ratified by the parliament.

Under the Agreement the dividends paid by a company, which is resident in one Contracting State to a resident of the other Contracting State, may be taxed in that State, (i.e. the country of recipient).

However, such dividends may also be taxed in the State of which the company paying the dividends is a resident, according to the law of that State, but the tax so charged shall not exceed in the aggregate 20% of the gross amount of the dividends.[7] This provision is in line with the T.I.D.R. rules of Indonesia.

Although the afore-mentioned provision is only effective in cases between the Netherlands and Indonesia, I presumed that this principle will be extended to other tax agreements with other countries. A more complex problem arises where the shareholder receiving the dividends is a company holding at least 25% of the issued capital of the company paying the dividends. We call this the "substantial holding" or in Dutch "Deelmeming".

A substantial holding is a close relationship and in most cases inherent to an influential position. The Indonesian Corporation Tax Act provides that if a domestic holding company as a shareholder receives dividend from another company in which it has a substantial holding, then the dividend received will not be deemed to be a part of the taxable profit.[8]

A holding company with domicile outside Indonesia will not be subject to Indonesian Corporation Tax, so the provision of article 9, Indonesian Corporation Tax Act, as mentioned above, will not be applicable.

If the foreign country in which the recipient of the dividend has his domicile, does impose tax on these proceeds, this will result in double taxation of the same income.

7. Art. 9 para. 1, 2. Tax Treaty Netherlands-Indonesia: Has not been published yet.

8. Art. 9 in conjunction with art. 5 para. 2. Corporation Tax Act. See Soemitro Suppl. III p. 186 & 187.

The protocol of the Netherlands-Indonesia Tax Treaty, in para. VI[9] pertains to holding companies and provides a stipulation, that notwithstanding the provision of article 9 para. 2 of the tax treaty, Indonesian Tax on dividends, paid by a company resident in Indonesia, to a company resident in the Netherlands, and holding directly at least 25% of the capital of the company paying the dividends, shall not exceed in the aggregate 10% of the gross amount, *provided that the receiving company will not be liable to tax in the Netherlands.* This condition is aimed to prevent a tax shifting to the Netherlands.

(Compare the provision of the Model Tax Treaty of the O.E.C.D., article 10 para. 2 which provides, that if the recipient is a company which holds directly at least 26% of the capital of the company paying the dividend, then such dividend may be taxed in the State of which the company paying the dividend is a resident, but the tax so charged shall not exceed 5% of the gross amount of the dividend.)

1.1.2. *The Taxation of Interest*

A loan may be secured by a mortgage on immovables situated in Indonesia or it may be made without any guarantee. Irrespective of whether the loan has been given to an enterprise in the frame of F.C.I.L. or outside the F.C.I.L., the interest in both cases, will be subject to T.I.D.R. and will be treated similarly.

T.I.D.R. shall be levied on the proceeds (derived from *loan of money)* in whatever form or under whatever name.

a. to bodies domiciled and conducting business in Indonesia;

b. to individuals residing and conducting business in Indonesia;

c. to permanent establishments carrying on business in Indonesia;

d. to the Central and Regional Government of Indonesia in the form of bonds and treasury papers.[10]

However the *liability to income tax* of interest from loan secured by a mortgage and of interest from loan without mortgage, differs. Non residents deriving interest from a loan which is secured by a mortgage on immovables in Indonesia will be liable to Indonesian Income Tax. The T.I.D.R. so withheld at the source will be credited against the income tax due.

On the other hand non residents who derived interest from a loan which is *not secured by a mortgage*, are not liable to Indonesian Income Tax, so the T.I.D.R. withheld will be a final levy, because it cannot be credited against the income tax.

Another juridical problem exists with regard to mortgage. Mortgages according to existing Indonesian law can only be settled on immovables. But from my experience I note that according to foreign law, mortgage or hypothec on airplanes is quite possible.

9. See copy of the original text of the Treaty p. 38.

10. Art. 1 T.I.D.R. See Soemitro Suppl. IV p. 377.

If a loan is secured by such a mortgage on airplanes and is registered in Indonesia, will Indonesia accordingly impose income tax on the proceeds (interest) of such a loan received by a non resident? It is not my authority to answer this question.

Let us take into consideration now, the international provision on this subject available in Indonesian tax legislation.

Article 10 para. 1 of the tax treaty between the Netherlands and Indonesia contains the basic rule, that interest paid to a person or body will be taxable in the country of the recipient.

However such interest may be taxed in the State in which it arises, according to the law of the State. The tax so charged shall not exceed in the aggregate 20% of the gross amount of the interest.[11]

Notwithstanding the above mentioned provision the tax levied by the State in which the interest arises, shall not exceed in the aggregate 10% of the gross amount of the interest if:

a. the interest is owed by:

   1. a bank or

   2. a financial institution or by

   3. an enterprise mainly engaged in the activities in the field of agriculture plantation, forestry, dairy farming, mining, manufacturing industries, transportation, people's housing projects, tourism, infra structure or any other field of production and,

b. the interest is derived by a bank or financial institution or by another enterprise.[12]

But recently by decree of the Minister of Finance No. KEP/502/MK/II/7/1973 of July 3, 1973, 50% of the amount of T.I.D.R. on interest of foreign loan has been declared to be out of collection. This provision is generally applicable without any condition or restriction. In my opinion this decree undermines the provision in art. 10 para. 2 and 3 of the tax treaty.

An individual money lender, resident in the Netherlands, who received interest from a loan to a production enterprise, a bank or other financial institution in Indonesia, as mentioned above, according to the provision of the tax treaty is not eligible for the reduced rate of 10% merely because of the fact that the money lender is not a bank, a financial institution or other enterprise particularly mentioned in the tax treaty. But if based on the decree of the Minister of Finance as mentioned above, the T.I.D.R. on interest will only amount to 10%. The Director General of Tax is authorized to make further regulations for the implementation of this decree. I wonder how far he will go in restricting the general

11. Art. 10 para. 2. Tax Treaty Netherlands-Indonesia p. 14.

12. Art. 10 para. 3 *ibid.*

use of the decree in question, so that the provision of the decree will be in line with the provision of the tax treaty. If the creditor is a bank, a financial institution of other enterprise, this case will not create any difficulties.

1.2. *The taxation of the enterprise in Indonesia engaged in business in the frame of F.C.I.*

As I have explained above it is a prerequisite that enterprises in the frame of Foreign Capital Investment, operated wholly or for the greater part in Indonesia must be a legal entity organized under Indonesian Law and having its domicile in Indonesia. Being a resident company it will be subject to Indonesian taxes.

To stimulate and to encourage foreign investors to be willing to invest their capital in Indonesia, facilities have been given. I do not intend to go into details in this subject, but I believe it is worth noting that the following facilities have been made available.[13]

1. *Capital Stamp Duty*

   Exemption from capital stamp duty on issued and paid up Capital, originating from foreign capital investment.

2. *Import duty and Sales Tax*

   Exemption or reduction of import duties and exemption from sales tax on import at the time of importation in Indonesia of fixed assets like machines, tools or other instruments needed for carrying out the said enterprise.

3. *Transfer Duty*

   Exemption from transfer duty on deed of ship registration if such registration is effected for the first time in Indonesia and is effected within the period of 2 years from the moment of commencement of production, with due regard to the nature of the enterprise.

4. *Corporation Tax*

   Reliefs in the field of corporation tax is given in the form of:

   a. offsetting of losses sustained in any year, against profits of the following year, up to the limit of 4 years;

   b. offsetting of initial loss incurred during the first 6 years from the moment of establishment; without any limitation.

   c. accelerated depreciation pursuant to article 4 para. 4 of the Corporation Tax Act and the Decree of Depreciation of 1953.

   d. Investment allowances. A deduction of 5% per year of the amount of additional Investment from profit before taxes, to be spread over the first four years, therefore maximum 20%.

13. See Soemitro, Taxation and its function as to create a favorable climate for private capital investment, *op. cit.*

5. *Dividend Tax*

Exemption from dividend tax for a period of two years beginning from the moment the enterprise starts it commercial production, provided such dividend is exempt from profit tax in the country of recipient. This two years exemption may be extended with an additional tax free period as stipulated in article 16 para. 2.

6. *Tax Holiday*

The Minister of Finance is authorised to grant new bodies that invest their capital in the field of production which is declared by the Government as a priority enterprise, an exemption from corporation tax for a period of two years beginning from the moment the enterprise starts its commercial production. This period may be extended to a maximum 6 years if prescribed conditions are fulfilled.

2. *Foreign Investors who invest their capital in Indonesia not in the frame of F.C.I.L.*

2.1. The foreign investor may invest his capital in an ordinary enterprise in Indonesia in the form of shares;

2.2. The foreign investor may invest his capital in an ordinary enterprise in Indonesia in the form of loan;

2.3. The foreign investor may directly invest his capital in an enterprise in Indonesia, which will be deemed as a permanent establishment.

2.1. Dividend received by a non-resident investor from an ordinary enterprise carried on in Indonesia not in the frame of F.C.I.L. is subject to dividend tax (T.I.D.R.) at a flat rate of 20%. This tax is levied at the source. The problem we are facing is whether such dividend can be transferred abroad. Properly speaking this is more a monetary policy problem than a tax problem. We notice that the liability to tax of dividend received from enterprises in the frame of F.C.I.L. differs from that received from enterprises not in the frame of F.C.I.L. Only if the qualifications set forth in the F.C.I.L. are not fulfilled, will both dividends be subject to the same tax rate.

Dividend received by a *non resident shareholder* who holds more than 25% of the issued capital, of the company paying the dividends (substantial holding), is treated equally as dividend received by a common shareholder.

2.2. Interest from a money loan received by a non resident investor from an enterprise in Indonesia, whether in the frame of F.C.I.L. or not, and irrespective of whether secured by a mortgage or not, is liable to T.I.D.R. at a flat rate of 20% the amount of which by decree of the Minister of Finance is reduced to 10%. What has been said under No. 1.1.2. is also applicable here.

2.3. Non resident investors who directly invest their money in Indonesia in an enterprise which is carried on by themselves or by a representative or proxy, or by way of permanent establishment, are liable to Indonesian Income Tax. (Individual Income Tax or Corporate Income Tax). The tax rate of Individual and Corporate Income Tax differs.

Our tax legislation does not define 'permanent establishment'. So, for the implementation of it we are obliged to apply the terms as laid down in the draft of the Model Tax treaty of the O.E.C.D. until recently, since we have concluded the Tax Treaty with the Kingdom of the Netherlands for the avoidance of double taxation and the prevention of fiscal evasion.

The term Permanent Establishment means a fixed place of business in which the business of the enterprise is wholly or partly carried on.

The term Permanent Establishment includes especially:

a. a place of management;

b. a branch;

c. an office;

d. a factory;

e. a workshop;

f. a farm or plantation;

g. a mine, an oil well, quarry or other place of extraction of natural resources;

h. a building site or construction etc. where such activity continues for a period of more than three months, it being understood that in the case of construction, installation or assembly project with respect to machinery or industrial equipment, a permanent establishment shall not be deemed to exist if such project continues for a period not more than 183 days;

i. the furnishing of services including consultancy services by an enterprise through an employee or other personnel, where activities of that nature continue within one of the two states, for a period exceeding in the aggregate of 183 days within any twelve month period.[14]

The term "permanent establishment" is not deemed to include:

a. the use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

b. the maintenance of stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

14. Art. 5 para. 2 Tax Treaty Netherlands-Indonesia.

c. the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d. the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for collecting information for the enterprise;

e. the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxilliary character for the enterprise.

We must be aware that juridically these provisions are only applicable to cases relating to the prevention of double taxation between the Netherlands and Indonesia. However I am convinced that this viewpoint will also form a guideline for relations with other countries.

Oil contractors

I would like to touch upon the problem of taxation of contractors or sub-contractors active in the oil fields, which has of late attracted the interest of foreign investors. In this context I am going to highlight the taxation of contractors/sub-contractors domiciled outside Indonesia.

To start with, it is worth mentioning that Indonesia in International tax affairs, adheres to the principle of domicile for resident tax payers, and the source principle for non resident tax payers. A non resident foreign investor will be taxed in Indonesia on his income derived from sources in Indonesia such as an estate, business activities or a permanent establishment in Indonesia. A non resident contractor accordingly will be liable to Income Tax in Indonesia if he has an office, a branch, a factory, a place of management, a workshop etc. in Indonesia, which answers the qualifications of a permanent establishment.

The presence of a farm, a mine, an oil well, quarry or other place of extraction of natural resources, will also qualify as a permanent establishment.[15]

However the furnishing of services including consultancy services by an entrepreneur, a contractor/sub-contractor through an employee or other personnel, will only be deemed to be a permanent establishment if the activities of that nature continue in Indonesia for a period exceeding in the aggregate 183 days within any twelve month period. Actually these are provisions of the tax treaty between the Netherlands and Indonesia, and it is only speculative that these provisions will be generally applicable to similar cases of other countries.

Some sub-contractors with a domicile abroad are doing drilling activities for a contractor in Indonesia. He owns the drilling machines, he furnishes the skilled labour, and renders the services to a contractor in Indonesia but he does not own the right to mine or the crude oil.

15. See Supra.

If the drilling activities are exercised in Indonesian territory and the provision of article 5 para. 2 sub. para. i of the tax treaty as mentioned above is applicable, then no tax will be incurred, provided that such activities will not exceed 183 days.

But in the Netherlands-Indonesia Tax Treaty, further restrictions have been made with respect to this subject, laid down in art. III of the protocol, thus:

> "Notwithstanding article 5 paragraph 2, sub-paragraph 1, a permanent establishment shall be deemed to exist, if a resident of one of the two states carries on. *as a subcontractor* under instructions from an enterprise of the other state, prospecting operations for mineral resources in that other states, provided such prospecting operations continue for a period exceeding in the aggregate of 91 days within any twelve month period."

It should be added that in practice, the drilling activities in most cases will last more than six months so that no problem will arise in taxing the proceeds derived from the drilling activities.

With regard to this subject the Minister of Finance has issued a decree recently (decree No KEP. 914/MK/II/9/1973, Sept. 4, 1973) in which the "deemed profit" of drilling companies is fixed on 10% of the gross profit. By gross profit is meant compensation or payment of any kind received from the oil company as agreed upon in the drilling contract after having deducted the expenses for mobilization and demobilization of the tools into and from Indonesia, necessary for the drilling operations, and the amount to refund the expenses of the drilling company which is done on behalf of the oil company to purchase equipment, which should not be borne by the drilling company (Decree of the Director General of Taxes No. D. 15 4/II/D2/1-43/73. Sept. 5, 1973). The Income Tax due (M.P.S.) is fixed on 4½% of the gross profit, while the T.I.D.R. is fixed on 1.1%, together constituting an effective rate of 5.6% from the gross profit.

Another problem arises if the drilling activities take place on the continental shelf, outside Indonesia territorial waters. Indonesian territory includes the whole territory of the former "Netherlands Indies" and recently the 12 mile territorial water boundary has been adopted.[16] In the tax treaty between the Netherlands and Indonesia this problem has not been dealt with. The treaty states that "Indonesia" refers to "the territory of the republic of Indonesia and the parts of the seabed and subsoil under the adjacent seas, over which the Republic of Indonesia has sovereign rights in accordance with International law."

Since the 1968 Geneva Conference on the Law of the Sea, the meaning of Continental Shelf has been generally accepted by the participating countries, and is used to refer to—[17]

a. the seabed and subsoil of the submarine areas adjacent to the coast but outside the areas of territorial sea, to a depth of 200 meters or beyond that limit, to where the depth of the superadjacent waters admits to the exploitation of the natural resources of the said areas.

16. Law No. 4 Prp. 1960 February 18, 1960. S.G. 1960 No. 22.

17. Art. 1 Geneva Conference on the Law of the Sea.

b. the seabed and subsoil of similar sub-marine areas adjacent to the coast of island.[18]

The rights of the coastal state over the continental shelf do not affect the legal status of the superjacent waters as high seas or that of the airspace above those waters. (art. 3 Geneva Convention). We may conclude that the coastal state has only the right to explore and exploit the continental shelf, the seabed and the subsoil. The President of the Republic of Indonesia on 17 February, 1969 made a declaration on the continental shalf of Indonesia that read as follows:

> "All mineral resources and other natural resources including living organisms of a secondary species found at the bottom of the sea (seabed) and land beneath it (subsoil) along the continental shelf, but outside territorial waters of Indonesia, as provided in Act No. 4 Prp. 1960, up to a depth limit which enables their exploitation and operations, shall constitute property of Indonesia and stay under its exclusive jurisdiction."[19]

May I stress, that *the mineral resources only* constitutes property of Indonesia, but it is outside the territory of Indonesia, even though Indonesia claims to have jurisdiction over it.

If a non resident sub-contractor derives income from drilling operations of mineral resources in the continental shelf, will such income be taxable in Indonesia?

We face two alternatives:

1. Because the taxpayer is a non resident and the source of income is outside the territory of Indonesia, the income will not be liable to Income Tax.
2. In the declaration it is stated that the mineral resources constitute property of Indonesia and Indonesia claims to have jurisdiction over it. As Indonesia has the authority to permit the exploration and exploitation of the mineral resources, logically it has also the authority to tax the proceeds derived from such resources, although it is outside the boundaries of Indonesian territory.

To give a juridical basis to this standpoint at the end of 1972, an Act on the Continental Shelf was passed by the parliament in which Chapter VI (article 9) contained the provision that all activities, events, equipment etc. which take place or were installed for the purpose of exploration or exploitation of mineral resources on the continental shelf, safety zone and restricted anchorage zone, are fully subject to Indonesian legislation.

I am confident that Indonesia will adopt the attitude which is most beneficial to itself.

Another point with regard to tax jurisdiction which also should be taken into consideration is the doctrine of archipelago of Indonesia. Indonesia being an archipelago, consisting of more than 13,000 islands and islets adheres to the principle that considers the archipelago as a unit, irrespective of the distance between the islands of the archipelago.

18. Dr. Mochtar Kusumaatmadja: Penggalian Kekayaan Alam didasar laut dan tanah dibawahnya dan Hukum International p. 7, Inaugural speech Padjadjaran University March 1, 1969.

19. Article 1 of the Declaration of the President of Indonesia.

This viewpoint is in conformity with the standpoint of the American Institute of International Law in its project No. 10 of 1926, which closely resembles the Alvarez proposal made to the International Law Association in 1924 in Stockholm. A more recent and most significant contribution by an individual scholar to the subject is the study prepared by the well known Norwegian jurist Jens Evensen at the request of the secretariat of the United Nations in preparation for the 1958 conference on the Law of the Sea. In the conclusion of his study he offered the following proposal with regard to an outlying archipelago.

> 1. In the case of an archipelago which belongs to a single state and which may reasonably be considered as a whole, the extent of territorial sea shall be measured from the outermost point of the outermost islands and islets of the archipelagoes. Straight baselines as provided for under article 5 may be applied for such delimitation.
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> 2. The waters situated between and inside the constituent islands and islets of the archipelago shall be considered as internal waters with the exceptions set forth under paragraph 3 of this article.
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> 3. Where the waters between and inside the islands and islets of an archipelago form a strait, such waters cannot be closed to the innocent passage of foreign ships.[20]

May I recall the Geneva Conference on the Law of the Sea of 1958 which was unable to solve the problem of archipelagoes. In the final draft articles of the Law of the Sea adopted by the International Law Committee, there was no provision on archipelagoes. The failure of the International Conference on the Law of the Sea to deal with the matter was not so much caused by a failure to recognise the validity of this case, but rather disagreement on some problems of a technical character. There seems to have been difficulty in the definition of "archipelago" as a geographical concept.[21]

Indonesia and the Philippines as outlying archipelagoes apply the principle of treating the archipelago as one unit and it can be said that the delimitation is applied for all purposes, not merely for the protection of resources.

The waters between and inside the islands and islets must be considered as internal waters, although it exceed twice the breadth of territorial waters (2 x 12 miles). For tax purposes the regime of the archipelago also applies without restriction. Drilling activities in internal waters will be deemed to take place in Indonesian territory and accordingly liable to Indonesian tax.

Finally I want to deal with the taxation of royalties, received by foreign investors.

By royalties are understood, remuneration or payment of any kind received as a consideration for the use of or the right to use copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process

20. Dr. Mochtar Kusumaatmadja LL.M. Regime of archipelago, problems and issues. Speech prepared for the VII meeting of The Law of the Sea Institute, University of Rhode Island, June 19 1972. Tri Panca Warsa, Padjadjaran University p. 149.

21. *Ibid.*, p. 152-153.

for the use of or the right to use industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experiences. Quite frequently foreign holding companies received royalties from Indonesian enterprises for the use of patent rights, industrial inventions or discoveries, copyrights etc. Such remuneration is subject to the Indonesian T.I.D.R. at a flat rate of 20%.[22]

According to article 12 of the O.E.C.D. draft tax treaty, royalties shall be taxable only in the State in which the recipient has his residence.

Indonesia, contrary to this principle, assumes the attitude, as we can observe in article 11 of the Netherlands-Indonesia tax treaty, that the State in which the royalty arises will also have the authority to tax such income provided that the tax so charged shall not exceed the aggregate of 20% of the gross amount of the royalty.

Notwithstanding the provisions mentioned above, the tax levied by the State in which the royalties arise shall not exceed in the aggregate:

a. 10% of the gross amount of the royalties if the royalties consists of payments of any kind received as a consideration for the use of, or the right to use any copyright of scientific work, or industrial, commercial or scientific equipment, or for information concerning scientific experience.

b. 5% of the gross amount of the royalties, if the royalties consist of payment of any kind received as a consideration for the use of or the right to use inventions or discoveries in the field of technology and industry, such as patent, trade mark, design or model, plan, secret formula or process, or for information concerning experience with respect to production and sale (know how).

Although these provisions only apply to royalties received in the Netherlands or in Indonesia, I am confident that this attitude will form a guideline for future similar subjects.

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22. Art. 1 para. d of the Act on T.I.D.R. as amended lately by Act No. 10 year 1970 S.G. 1970 No. 45. See Soemitro Suppl. IV p. 362.

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