NEGOTIATION OF SELECTED PROVISIONS OF BILATERAL TAX TREATIES

(THE INDONESIAN EXPERIENCE)*

I. General observations.

1. When foreign enterprises were given the opportunity to make their investments in Indonesia, it was to be foreseen that problems of international taxation would subsequently arise as a consequence. Since long seemingly forgotten, this particular area of taxation appears as something entirely new in Indonesia's tax-world.

Whereas Indonesia's neighbours Singapore and Malaysia for many years had several double-taxation agreements, only in 1970 Indonesia started its very first negotiation with the Netherlands. One should wonder why negotiations were initiated with a country geographically so distant from Indonesia. Furthermore, Indonesia and the Netherlands had no more close economic ties after the second world-war. However, it was no mere coincidence, because the event can be explained on historical grounds, consisting of various factors, including taxation which undoubtedly played a major role, since the Indonesian tax-system is an inheritance from the then Netherland-Indies government and consequently bears similar philosophies as contained in the Dutch tax-laws e.g. the economic double-taxation, which means that the same income is taxed twice; once at the corporate level and again when that income is distributed.

This system has been maintained ever since and it has become the general complaint of entrepreneurs that the tax-burden resulting from that system is too heavy. Indeed, 45% corporate tax and 20% withholding tax on the rest when distributed, adding up to a total of 56% of the net profit, leaves the foreign entrepreneur nearly no space to move.

When compared to Singapore's single income tax of 40%, it is clear that a difference of 16% is not negligible which is a consequence of the philosophy that two taxpayers exist, each independently from the other i.e. the legal entity and the shareholder.

Every tax-system has of course its own merits; it is however, undeniable that a single income tax forming a prepayment on the ultimate liability of the shareholder is less complicated to handle and has among others such advantages as:

* A paper delivered during the Colloquium on Indonesian law at the Faculty of Law, University of Singapore, 1973.

(1) the administration of a single income tax is easier, compared to that where both the corporate and the shareholder are taxed separately;

(2) there is no more reason for the company to be reluctant to distribute profits when no tax is imposed in addition, on paid dividends. A high rate of tax, as is the case in Indonesia, tends to encourage disguised distribution of profits under various devices, the consequences of which could impede the development of a sound capital-market which is so crucial to industrial-financing.

(3) in double-taxation negotiation, the problem of the withholding tax on dividends is evidently no more of any relevance, since no tax is being withheld on outgoing dividends.

2. In 1954, a tax-agreement actually was signed between Indonesia and the Netherlands. However, due to the political situation which was worsening between the two countries at that time, the agreement has never come into force. Although the agreement has been buried for 16 years, apparently the Dutch had kept it in their memory and they patiently bided their time. They came early in 1970 to explore the possibility of concluding a double-taxation agreement with Indonesia, after the law on foreign investment came into force in 1967 and economic relations between Indonesia and the Netherlands were normalized. After the Netherlands' first attempts, it was to be expected that other countries, having also economic ties with Indonesia must have the same desire as the Netherlands with regard to concluding a tax-agreement.

From the mere viewpoint of revenue Indonesia preferably concludes no tax-agreements at all, since such agreements are only restricting the taxing-power of a state. There are however, considerations other than those in relation to revenue, which contemplate the double-tax agreement issue from a wider angle. Many advantages are argued in favour of a tax-agreement beside those intentionally assumed thereto. It is undisputable that a tax-agreement ascertains to a certain extent, legal security for the foreign investor, which implies that the foreign business world will have more confidence in the Government of Indonesia.

Indonesia is aware that a tax-agreement will help the promotion of foreign investment which is designed to assist achieving greater welfare more rapidly in order to cope with the ever increasing demands of the community.

Most developing countries can rarely afford to reject foreign investment, when setting as their goal a fast industrialization of their economy, for which is needed sizeable amounts of capital and sophisticated technology. These two important factors are generally scarce in developing countries and must usually be imported from developed countries.

Sometimes, aware of their strong bargaining position, the foreign investors assert demands with respect to tax-reliefs which are, at the least not normal. Hopefully, this arrogant attitude is not adopted by their home-countries in double-taxation negotiations. Due to this unbalanced situation, it is unlikely that any tax-agreement between developed and developing countries has ever been negotiated on a quid pro quo

basis. The decision to conclude a tax-agreement however, is frequently strongly influenced by considerations of a highly political nature. In fact, the investor has no worry to whom he should pay tax, as long as he earns a fair return on his equity. This should not create a problem during the tax-exemption period, since tax is being suffered only in the residence-country. But it becomes different when he has to face taxation from two countries. Then, the problem of double taxation comes into play, obviously emerging from the different tax-structures existing in the source-country and in the country of residence. This double taxation will of course affect the tax-neutrality. Apparently, in order to restore this tax-neutrality, a double-taxation agreement is considered the most appropriate device. It is still questionable whether no better and simpler methods exist to achieve the same result e.g. by giving the taxpayer a complete refund of the tax paid in the source-country.

II. Permanent establishment

1. The problem concerning the taxation of a permanent establishment usually forms a matter which is discussed very extensively in double-taxation negotiations. The reason is that the source-state (mostly a developing country) wants to preserve its primary right to tax, while the other country claims to own that right by virtue of its status as the residence-state.

In fact, based on an extreme source-of-income theory, income which can be related, in any way, to a country, may be taxed by that country. The Indonesian company tax law enables the tax authorities to apply this extreme source-theory, so that for instance tax can be imposed on foreign profit of export, thereby assuming the existence of a permanent establishment. But this will of course be harmful to the Indonesian export-business because the tax, becomes a cost-factor which certainly will not help promotion of export.

What kind of fiscal attitude is adopted by Indonesia with respect to the taxation of a permanent establishment? In sub-para. 3 of Article 1 para. 1 of the company tax law it is provided that company tax is levied on profits obtained by entities not domiciled in Indonesia from business which is carried on through a permanent establishment situated in Indonesia. What business means is not defined but in para. 3 it is stipulated as an addition, that activities, performance of work or services whatsoever are regarded as business. The law does not specify either what a permanent establishment is. The elucidation of the law gives a short explanation which says that in assessing whether or not a permanent establishment exists, the economic relation between that permanent establishment and Indonesia shall be determinant. With this short explanation, the law actually does not say very much. This is quite understandable because it is unlikely that an exhaustive list could be made of activities and places of business which may be considered as a permanent establishment; thus, the law leaves the interpretation to the tax administrators. From old decisions of the court of appeals (after 1940 there were no decisions on permanent establishment cases) it is worth mentioning the case of a foreign enterprise which purchased goods through a commission agent in Indonesia and the case of a foreign

company which sent goods on consignment to an agent in Indonesia. In both cases, the court decided that there was no permanent establishment. This view of the court has now become rather old-fashioned.

In double-tax negotiations, Indonesia always requests to have para. 5 of Article 5 of the O.E.C.D. Draft Convention replaced with the following provision:

"An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, where such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise he would not be considered an agent of an independent status within the meaning of this paragraph."

This amendment which is an extension of the old formulation in the O.E.C.D. Draft Convention concurs with the Indonesian view. The experience proves that when the activities of an agent are wholly or almost wholly devoted to the business of the foreign enterprise, then, the agent in most cases has committed himself to certain obligations in favour of the foreign enterprise, so that he is in fact a dependent agent and consequently constitutes a permanent establishment of the foreign enterprise. Of course, to fulfill those obligations, the agent normally will receive certain compensation. Under such circumstances, nobody will contend that such an agent is not independent anymore. He is just an extension of the foreign enterprise. A different question, related to this problem, is how to compute the taxable profit of such a permanent establishment. Does attribution of profit answer the question satisfactorily? If that is an agreeable solution for all parties concerned, what part of the profit and what part of the expenses are to be allocated to the permanent establishment. The problem becomes more complicated when the goods are supplied by a foreign manufacturer directly to the Indonesian agent. What will be the cost of the goods for the agent?

2. Another issue in connection with the permanent-establishment article is the replacement of the provision in sub-para. g. of Article 5 para. 2 of the O.E.C.D. Draft Convention:

> "a building site or construction or assembly project which exists for more than twelve months;"

by the first alternative, proposed in the second meeting of the Ad Hoc UN Expert Group:

> "a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activity continues for a period of more than six months."

The term "installation" was not mentioned in the Expert Group's formulation but the addition is justifiable in the case of Indonesia. It is a fact that most sales of machinery or equipment to Indonesian factories are carried out on a "turn-key" basis, which means that the manufacturer sells a complete factory and will also take care of the installation, the

cost of which is naturally included in the sales-price. In the Expert Group meeting, members from developed countries remarked that there was no substantial difference between a straight export sale and a sale which required installation of the equipment by the seller and that such installations were merely accessory to sales and therefore should not give rise to a permanent establishment. The practice is that in most cases the Indonesian buyer has no choice, for he is compelled to buy the equipment on the seller's terms which includes installation. In that way the installation is arranged to appear as accessory to the sale. It is no more than fair that in such a case the income derived from the installation shall be taxed by the state in which the activities were performed. The problem of how to estimate the amount of taxable income will immediately arise when a permanent establishment is assumed in relation to these installation-activities.

3. The "furnishing of service" clause as it has been formulated in the second Expert Group meeting and which reads as follows:

> "The furnishing of services including consultancy services by an enterprise through employees or other personnel where activities of that nature continue within the country for a period or periods aggregating more than six months within any twelve-month period;"

also gives rise to controversies in negotiations.

It is indeed in Indonesia's interest to have this provision adopted in bilateral tax-agreements. The business in the rendition of services is becoming increasingly important in Indonesia. This is not surprising because Indonesia's business society is becoming more aware of the value of good service and the greater part of the service know-how and expertise that are needed is coming from outside of Indonesia. For the use of these services, large amounts of payments are involved which are deductible as business expenses and will reduce the tax liability of the Indonesian taxpayer. Should Indonesia leave these payments untaxed? This will create an unfair situation for the Indonesian taxpayer who is in the same business as the foreign service-rendering company and who is obliged to pay tax on his income. Even under the same tax-conditions, it is really hard for the Indonesian entrepreneur to be in competition with a foreign enterprise with definitely more experience and expertise.

4. Para. 3 of Article 5 of the O.E.C.D. Draft Convention excludes several business activities from the permanent establishment concept e.g. the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise.

In accordance with the view of the developing countries in the first meeting of the Ad Hoc UN Expert Group, to which Indonesia fully subscribes, the word "delivery" is to be deleted. Although Indonesia does not allow foreign trading houses to operate in Indonesia, it is conceivable that a representative of such a house could freely make deliveries out of a bonded warehouse, the profit of which is not taxable if the word "delivery" is to be maintained in the phrase. In this way the foreign representative has avoided two regulations at the same time; first the regulation which says that foreign companies may not conduct

any commercial activity in Indonesia and second the tax provisions concerning the permanent establishment.

One can imagine what the impact is on local business when such transactions are tolerated. Furthermore, it is very doubtful whether the tax-authorities of the residence-state will get full information of those activities. This could happen when the enterprise is multinational which acquires the goods from associated companies. This being the situation, if such a foreign enterprise is exempt in the source-state, the residence-state might not collect as well the adequate amount of tax because of lack of information. Hence, the most natural thing for the residence-state to do is to give the source-country the primary right to tax profit from deliveries as is meant in para. 3 of Article 5 of the O.E.C.D. Draft Convention. Apart from these tax-considerations, when the word "delivery" is kept in the relevant clause, it might give rise to ambiguity as to the policy of the government which is laid down in the prohibition for foreign companies to do trading business in Indonesia. "Delivery" might be interpreted as if it implies that enterprises of the other signatory states are excluded from that prohibition, provided that the delivery is not carried out through a permanent establishment.

III. Business income

1. In a tax agreement only business income or profit of a permanent establishment is dealt with due to its pecular status. It is no resident of the source-country but it has a place of business or carries on an activity which is of a more or less permanent character. However, it is still a part of the mother-company in the residence-state. Because of this situation a permanent establishment is liable to tax in the residence-state and in the source-country as well. The problem will not arise when the two states have the same tax-system so that business income will be treated on the same footing in both countries and in consequence double taxation can be avoided. Presumably this ideal situation will never exist.

Article 7 of the O.E.C.D. Draft Convention provides according to the commentary thereon a set of rules of reference to which the profits made by the permanent establishment are to be calculated. The term "rules of reference" is self-explanatory. The article does not pretend to lay down a series of precise rules for dealing with every kind of problem and contains only the essential principles to be used in attributing profits to a permanent establishment by the state in which it is situated. It does not elaborate the term "attribution", it only says that there shall be attributed to that permanent establishment the profits which it might be expected to make if it were a distinet and separate enterprise and dealing wholly independently with the enterprise of which it is a permanent establishment. Hence, reading this article one must come to the conclusion that in the implementation of this provision, the law existing in each country shall prevail.

In old times when most of the permanent establishments were owned by companies resident in the Netherlands and the tax-administration in the Netherlands as well as in the Netherland-Indies were virtually in one hand, it goes without saying that any problem in connection with

attribution of profits was probably resolved in a most co-operative way. There were however, several cases brought into the court of appeals. In the case of a branch office in Indonesia which imported goods from the Netherlands where the head-office did the purchasing, the court decided that 75% of the profit was to be attributed to the Indonesian branch. In a case of importation by the branch of monopoly goods, the court believed that the income of the branch should be fixed at 90% of the profit. With regard to tobacco exported by the Indonesian subsidiary to the parent-company in the Netherlands which took care of the sale, it was decided by the court that 2/3 of the profit be taxed in Indonesia. In case the tobacco was sold at an auction, the branch-profit was 100%.

These few examples demonstrate that each case has to be judged in accordance with the material factors. Because the Dutch and the Netherland-Indies tax laws had very similar methods of computation of the income, there were probably no serious disputes on the allocation of expenses and the method of division of profit could be applied satisfactorily. But in the O.E.C.D. Article on business profits, the permanent establishment is considered as it were a distinct and separate enterprise. Therefore, another provision which is related to executive and general administrative expenses is made to allocate them to the permanent establishment. This provision leaves also open the method for the allocation and here again the existing regulations of each state will prevail.

2. Para. 5 of Article 7 of the O.E.C.D. Model prohibits the source-country from taxing profits which may be assumed to arise from the mere purchase by a permanent establishment of goods and merchandise for the enterprise. In all negotiations Indonesia has accepted this clause although in accordance with the law Indonesia may tax such an activity, but this will mean that export is taxed and very likely this will hamper the export-promotion. Revenue-considerations are here in the second place. It is more important to earn more foreign exchange which is essential for a rapid economic development.

3. A rather new issue in tax-agreement negotiations is the "force of attraction" principle. This topic was discussed extensively in the second Ad Hoc Expert Group meeting with the developing countries as its supporters. This "force of attraction" principle applies especially to transactions conducted directly by the home office, of goods and services which are similar in nature to those conducted by the permanent establishment. In that meeting the following amendment was found to para. 1 of Article 7 of the O.E.C.D. Draft Convention:

"If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; or (b) sales of goods or merchandise of the same or similar kind as those sold, or from other business activities of same or similar kind as those effected, through that permanent establishment."

This formulation is rather complicated. Simplified, it means to say that if an enterprise has a permanent establishment in the other State for the purpose of selling goods or merchandise or carrying other business

activities, sales or activities of the same or similar kind may be taxed by that other State, even when those activities are conducted without any connection with the permanent establishment. It is justifiable that the developing countries are anxious to get this amendment because of their unpleasant experiences, although it gives the impression as if the developing countries are extending their taxing-power beyond their territory by imposing a tax on profit earned by foreign exporters. It is indeed not an easy problem to solve. Like the other developing countries Indonesia is also familiar with this practice of head-office by passing the Indonesian branch. Indonesia wants to have this "force of attraction" clause as a general rule so as to reduce disputes with regard to the determination whether particular activities were or were not related to the permanent establishment. The whole picture however, will change when the transaction conducted by the foreign enterprise which has a permanent establishment in the other country was totally unrelated to that establishment. In such a case, the Indonesian tax-administration will very likely be reasonable enough to exempt such a transaction, but the enterprise will then have the burden of proof. If a dispute arises, the establishment will have as every other taxpayer, access to the use of all remedies provided by the law.

IV. Dividends, interest and royalties

1. In 1970 Indonesia introduced a new law which is a law concerning the withholding-tax on interest, dividends and royalties. This law replaces the withholding-tax law on dividends of 1959. Before the new law was in force, interest and royalties were liable to company tax. When this company tax law was promulgated in 1925 royalty payment for technical know-how etc. had conceptionally not the meaning now prevalent in modern business. The elucidation of the law explicates that certain royalty payments are taxable, those which can be considered as payments out of profit. There was apparently a tendency to have royalties confined to payments in connection with concessions of mining or other extractive business. The concessionaire may lease the property for which he receives a certain compensation which is called royalty.

Obviously according to the company tax law the possibility of taxing royalty payments is tied to the existence of a permanent establishment. The big problem is how to reach the foreign enterprise when in reality no permanent establishment exists in Indonesia.

With the introduction of the tax law on dividends in 1959 and the new withholding-tax law in 1970 a new concept of taxing Indonesian-source income has entered Indonesia; the source-of-income principle becomes more articulate in Indonesian taxation.

It is of course unavoidable that this new taxing-approach gives rise to double taxation; the residence-country will also levy a tax on foreign-source income. While recognizing the taxing-right of the source-country, the residence-country generally objects to the withholding-rates applied by the source-state. In most negotiations Indonesia is prepared to reduce the rate, with the understanding however, that the agreement is to be viewed as a package.

2. Some interesting questions emanating from Indonesia's negotiations are among others:

(1) How will distribution of profit of a partnership to a non-resident partner be treated. This is a logical question taking into account that a partnerships is treated as a limited liability for tax purposes. Would the distribution be taxed as if it were a dividend? The answer is affirmative according to letter of Article 1 of the Tax-law on interest, dividend and royalty of 1970.

(2) Why is remittance of money from a permanent establishment taxed, for this money might not be forming a profit for the foreign enterprise in case it suffers a loss. In addition, a remittance might be either repatriation of capital or a loan. Nevertheless, this tax on remittances is justifiable seeing it from the Indonesian viewpoint of taxation, for:

a. the permanent establishment's profit is to be computed as if it were a distinct and separate entity; and

b. payment of dividends forms income for the resident-taxpayer and is taxed accordingly. For equity reasons the non-resident taxpayer must be treated on the same footing.

In past negotiations Indonesia agreed to a reduced rate for this type of distribution.

(3) Is para. 4 of Article 4 of the withholding-tax law applicable to a foreign owner of a substantial holding? This paragraph provides that no tax shall be levied on proceeds obtained in the form of interest and royalty, provided such payments are not deductible as business expenses on account of the fact that the recipient owns a substantial interest in the company. At first sight it looks as if those payments are exempt from withholding-tax; but what does the company tax law say? Article 9 provides that profits as defined in Article 3 do not include aforementioned payments.

Article 3 stipulates that profit is defined as the sum of the benefits derived from a business. An enterprise not domiciled in Indonesia can carry on a business in Indonesia through a permanent establishment.

The conclusion is that only in the case of the existence of a permanent establishment will the provision of para. 4 of Article 4 apply to the foreign enterprise, meaning that aforesaid payments are exempt. The principle is that both of them, the owner of the substantial holding as well as the company, must be situated in Indonesia. In all tax-agreements (except for one) concluded by Indonesia a tax sparing credit clause has been included. Indonesia recognizes the taxing-rights of the capital exporting country but it is not fair when that country will obtain more revenue at the expense of the source-country which accords a tax exemption to the foreign investor. Hence, a tax sparing credit provision is to be adopted in Indonesia's tax-agreements. In Indonesia's experience the other countries, except for the Netherlands, request that the tax incentives accorded or to be accorded by Indonesia are to be agreed upon by the competent authorities before those incentives are operative

for tax sparing credit purposes. This requirement is not acceptable for Indonesia for it indulges the image as if the other country may interfere in Indonesia's tax-policies.

2. From the viewpoint of taxation policy interest is in a sense not entirely separable from dividends. The entrepreneur has several choices of financing his undertaking, he may elect either equity or loan. Apart from other considerations, a leading principle which plays definitely an important role in his judgment is the cost of the money involved in either type of financing and one of the factors burdening this cost is undoubtedly the tax on the interest. It appears as if the lender has to pay the withholding-tax on the interest payment but the practice proves that the borrower has to, bear the tax-incidence which will increase the cost of money. If there is no additional cost involved on money lent in the form of tax on interest and if the investor still has a fair return on his equity he will presumably without hesitation elect loan as the means of financing his needs. This will likely not benefit the balance of payments of the country where the foreign investor carries on his enterprise. It is evident that tax will have some influence towards the investor's behaviour which may not be congruous with state's interest. It is important for the state to have to a fair extent some control in the financing matters of the enterprise and therefore, as tax might influence the investor's decision, the policies of both the withholding tax on dividends and on interest should be shaped with due regard to their inter-relationship. This is also the leading principle followed by Indonesia in tax-agreement negotiations. However, one must also reckon with the reality. It seems that most enterprises are more in favour of loan-financing than to invest equity, particularly in developing countries. Tax-considerations may not be the only reason. Facing this reality, some adjustment to the aforementioned policy should be made as to facilitate the import of capital for the enterprise. This course has been taken by the Indonesian government, the proof of which is the Minister of Finance's decree reducing the general withholding-tax rate on interest of foreign loans to 10%. In a tax-agreement, for instance in the one concluded with the Netherlands, that rate has also been reduced to 10%, but not in general, for interest on loan for general trade is excluded. This provision does not cover import-credits and this is in line with government's policy with respect to import of consumption-goods.

Usually no problems of a fundamental character arise in Indonesia's negotiations. In deviation with the provision as it has been agreed upon in the Netherlands agreement in connection with interest on loan secured by mortgage on a property situated in one of the contracting states, Indonesia has agreed in other tax-agreements to tax this kind of interest with the withholding-tax and not as business income. Another deviation is the taxation of income from profit-sharing bonds. With other countries Indonesia concedes to tax this type of income as interest and not as dividends. There are no particular problems involved with regard to the avoidance of double taxation of interest. Each of the two countries shall allow a tax-credit which equals either the tax on that interest computed in proportion to the total tax liability, or the tax paid in the other country, whichever is the lower.

In fact this does not concur with Indonesia's unilateral measures for the avoidance of double taxation. In the case of off-shore interest this

regulation provides that in the taxable income is to be included only the nett interest after tax.

3. According to Indonesia's withholding-tax law a 20% tax is to be withheld by the payer on royalty payments remitted to a non-resident recipient. The tax is to be computed on the gross amount. Royalties were previously, before the withholding tax law of 1970 came into effect, taxed as business income. This is actually in conformity with the desire of the know-how exporting countries as one may learn from the reports of the Ad Hoc Expert Group. The royalties will then be taxed on a nett basis allowing all kinds of cost to be deducted.

However, realizing that taxation of royalties on an income basis will certainly create many difficulties, for instance the allocation of the expenses claimed to be attached to the royalty payment concerned, Indonesia elects to tax royalties with the withholding-tax which is a final tax for the non-resident recipient.

A problem encountered by the Indonesian tax administration is the amount of royalties paid by an Indonesian company to the parent who does not own 50% or more of the company shares.

In the case of more than 50% ownership the amount is not important anymore because the royalty payments are not deductible, but when the parent owns less than 50% and the payments are to be recognized as deductible expenses, then the logical question will arise whether the royalties are genuine or not especially when it involves production where obviously not much know-how is needed. Then those royalties look more like dividends than royalties. In case the royalty payments are really made to acquire technical know-how, is the parent not adequately compensated when the actual costs are reimbursed?

These and more questions with regard to royalties are not covered by a tax-agreement. Indonesia has in its tax-agreements basically adopted the O.E.C.D. Draft Convention. The tax-credit provision concerning royalty is equal to that in relation with interest.

S. K. SUTANTO*

* Director for Legal and International Tax Affairs, Ministry of Finance, Republic of Indonesia.