Indonesian tax news

Highlight

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War against abuses of tax treaties continues

Abuses of tax treaty have been an issue of concern of the Director General of Taxation (DGT) for a long time. A series of tax regulations have been released by the DGT to crack down this practice, the most recent ones being Regulations 61 and 62 issued in early November. Previously, several regulations were released calling for the beneficial owner status to claimants of tax treaty relief. Another regulation was also issued in 2005 to suspend withholding tax (WHT) exemption on particular interest income provided by the Indonesia-Netherlands tax treaty pending mutual agreement between both governments on the mode of application (MoA).

Table 1
Qualifications as a legitimate resident

Reg. 62 requires that a claimant of tax treaty relief must satisfy the following conditions to qualify as a resident of a particular tax treaty country partner as meant by the relevant tax treaty (legitimate resident) and accordingly is entitled to the tax treaty relief.

No involvement in abuses of tax treaty
An abuse of tax treaty may be deemed to exist if the following conditions prevail:

- Transactions have no economic substance
- A transaction is structured in such a way that its legal form is inconsistent with the economic substance merely to enjoy tax treaty relief
- The income recipient is not the beneficial owner.

The income recipient is the beneficial owner
The beneficial owner of a particular income means the recipient of that income who:

- acts not as an agent or a nominee and
- is not a conduit company.

Full-blown requirements

Regulations 61 and 62 not only address the general procedures that must be followed to claim tax treaty relief. They also set out conditions under which a claimant is considered a legitimate resident of a tax treaty country partner within the meaning of the relevant tax treaty and accordingly is entitled to the tax treaty relief. Additionally, Regulation 62 specifically provides for the applicable MoAs tied up with whether the administrative procedures are fully satisfied.

In this respect, if the administrative procedures are fully satisfied, an upfront WHT reduction or exemption in accordance with the relevant tax treaty will be applied. On the other hand, failure to fully satisfy the administrative procedure will result in upfront WHT in accordance with domestic tax legislation. A tax refund is only available when the administrative procedures have been fully satisfied.

Given their broad scope, Regulations 61 and 62 which will be in force on 1 January 2010 supersede all previous DGT regulations regarding beneficial owners and MoAs. As a consequence, the WHT exemption on particular interest income provided by the Indonesia-Netherlands tax treaty can now be applied provided that all administrative procedures are fully satisfied.

Certificate of domicile

A certificate of domicile (CoD) will continues to serve as the basic document to prove its holder’s entitlement to the tax treaty relief claimed. However, this can no longer be taken for granted.

Table 2
List of parties deemed not being engaged in an abuse of tax treaty

a. Individuals who acts not as an agent or a nominee
b. Institutions expressly mentioned in the relevant tax treaties or the ones mutually agreed between the Competent Authorities of Indonesia and the treaty country partner
c. Non-resident taxpayers not acting as an agent or nominee who earns income through a custodian from transfers of shares or bonds (other than interest and dividends) listed or traded on the Indonesian Stock Exchange
d. Companies whose shares are listed on a legitimate stock exchange; or
e. Legitimate companies

Above all, a CoD must be prepared using the form made available by the DGT. A claimant must fill out information therein which indicates among others that they qualify as the beneficial owner of the income in question. The CoD must then be legalized by the competent authority of the claimant's home country. Reg. 61 implies that the competent authority should verify the claimant's statements made in the CoD attachments before confirming their acceptance. The last but not least, a properly prepared CoD must be made available to the Indonesian party responsible for applying WHT before they file their monthly WHT returns.

It is uncertain whether the tax authorities of other countries will accept the new procedures. They may especially be concerned with the way a CoD must be prepared. From an Indonesian perspective, the DGT may need to clarify a number of technical issues which potentially can create other uncertainty. For instance, while there is a basis to combat abuses of tax treaties using a conduit company, the requirement that the income earned from Indonesia should be subject to tax in the recipient's home country may not always be consistent with the scope of application adopted by each particular tax treaty. Additionally, the DGT may need to correct a few possible typos in the new regulations.

Positive developments

A few positive developments are noteworthy from the release of Regulations 61 and 61. First, after more than four years, the DGT finally made a real step to solve the issue of MoA pertaining to WHT exemption on particular interest income provided by the Indonesia-Netherlands tax treaty. Similar MoAs are applicable for all claimants depending on the satisfaction of administrative procedures irrespective of their country of domicile. Residents of Netherlands may not need to feel to be treated differently.

What is meant by a tax treaty abuse and a beneficial owner has also been made clear and transparent (Ref. to Table 1). This is consistent with the OECD Model Tax Convention commentary. Additionally, the regulations also introduce the concept of legitimate company for the purpose of tax treaty relief claims (Table 3).

Table 3
Qualifications of a legitimate company

A company is regarded as a legitimate company if all the following conditions prevail:

a. The establishment of the company in the treaty partner country or the way a particular transaction is structured is not aimed merely at enjoying tax treaty relief; and
b. The company's business activities are managed by its own management which has adequate authority to carry out transaction; and
c. The company has personnel; and
d. The company has active business; and
e. The income earned from Indonesia is taxed in the recipient's country; and
f. The company does not use more than 50% of its total income to settle obligations with other parties, e.g. in the forms of interest, royalties, or other types of compensation.

Reg. 61 also specifically addresses tax relief that may be obtained on income earned from Indonesian Stock Exchange. This is done by designing a special type of CoD for non-resident parties who receive capital gains from transfers of shares or bonds listed or traded on the Indonesian stock exchange through a custodian. Overseas bank may also make use of this special type CoD.

Further implications

It is generally agreed that cracking down tax treaty abuses is in line with the underlying objective of every tax treaty. The DGT's passion to pursue this issue may have heightened following the recent G20's communiqué containing action plans among others to combat tax evasion. Nothing is therefore very surprising regarding the DGT's step. Nevertheless, the DGT may need to clarify certain issues that could potentially create uncertainty taking into account the reactions of the other tax authorities to the new procedures. Additionally, the DGT may need to correct a few typos in the new regulations.

For non resident taxpayers, obtaining tax treaty relief is apparently getting harder and harder from 1 January 2010. Indonesian companies paying income subject to WHT to non-residents may need to take special care before applying WHT reduction or exemption. They have to make sure that a proper CoD is readily available to them. Failure to observe this requirement may cost them significantly as they will be held responsible for the settlement of any WHT shortfalls and corresponding penalties if it is later found through a tax audit that the tax withholding has not been done correctly.

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