Tax
Indonesia

TaxFlash

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Practical aspects of applying tax treaty rates (Regs 61 & 62) – how easy will it be to obtain tax treaty relief and what are some of the issues involved?

In our last TaxFlash we outlined the new DGT regulations (61 and 62) regarding the new rules for claiming tax treaty relief. These new rules are one of the most significant changes in Indonesian tax policy in recent years and have a far-reaching impact. Whilst it is accepted that tax treaties should not be used in a tax abusive manner, the compliance burden that will now be imposed on genuine cross-border arrangements has many people questioning whether, at a practical level, tax treaties have been rendered ineffective.

In this issue:

In this issue we outline some of the common concerns and points that taxpayers should be considering in determining the impact of the new regulations on their business.

If a non-resident does not believe it has used a treaty in an abusive manner can the regulations be ignored?

A starting presumption for the new rules to apply is that there must be treaty abuse. Many entities will be of a the view that they are not using a particular treaty in an abusive manner as in the case, for example, of a regional holding company established in Singapore for commercial reasons, as opposed to any tax-driven reasons. However in practice it may be difficult to answer “yes” to all the questions in the form concerning the operations of the company (active business, employees etc) and a “no” answer to any of the questions means the treaty WHT rates cannot be used.

Whilst the regulations provide a refund mechanism for entities that believe WHT has been incorrectly deducted, the process is likely to be protracted.

Does a CoD have to be obtained for every payment made?

The manner in which the current CoD form is constructed appears to imply that a form should be completed for each transaction. This has been reinforced by the fact that the ITO is considering amending the form to allow an annual CoD to be obtained.

However, in our view, it is arguable that if the annual payment amount is known a CoD could be sought on an annual basis. Hopefully the ITO will provide clarity on this point soon.

As a tax withholder do I need to validate a CoD?

Based on the regulations, provided an original CoD is obtained from the overseas person, the withholder is under no obligation to validate the CoD, i.e. confirm whether the answers to the questions on the form are correct. However the withholder must check the form as outlined in Reg. 62 attachment 1.

In some respects the position of the withholder is clearer. For example, if no CoD is provided by the time the WHT is due then 20% WHT should be deducted (or a lesser rate for certain tax objects).

Will an overseas tax authority stamp the CoD form?

The question will most likely centre on whether an overseas authority believes they have responsibility for checking the validity of the form. Arguably all that is required of the overseas authority is to stamp a box confirming that the relevant person is a tax resident of the overseas jurisdiction, i.e. there is no obligation for them to validate the taxpayer's responses to the questions in the form. However the position is somewhat confused as it appears the overseas authority must stamp the form again (at the end) alongside a statement that "this form must be endorsed by the Competent Authorities." This could lead an overseas tax authority to believe that they have an obligation to check the correctness of the disclosures made.

If a number of significant overseas tax authorities refuse to stamp the CoD form the ITO will need to reconsider how it will deal with this issue, otherwise the relevant tax treaty will be rendered ineffective.

Even if this potential issue is resolved the timeliness of the overseas authority in stamping the forms needs to be considered. We anticipate that obtaining a stamp could take a number of weeks.

Can you obtain a CoD on time?

CoDs must be attached to the monthly tax return in which the income tax payable is reported. This means that the CoD has to be available before the submission deadline of the monthly tax return, i.e. by the 20th of the following month. This means CoDs need to be processed and obtained well in advance otherwise the withholder will have no choice but to deduct 20% WHT (or a lesser rate for certain tax objects). Careful planning will be required.

If the overseas entity is a company and it answers "no" to any of questions 7-12 in part V of the form, can a treaty WHT rate still be used?

Form DGT 1 Part V requires an overseas company to answer a number of questions concerning its business (questions 7-12). A "no" answer to any of these questions means a treaty WHT rate cannot apply. In substance it is a conduit company test. The tests are;

- The creation of the entity and/or the transaction structure is not motivated by reasons to take advantage of the benefit of the Tax Treaty.
- The company has its own management to conduct the business and this management has independent discretion.
- The company employs sufficient qualified personnel.
- The company engages in active conduct of a trade or business.
- The earned income is subject to tax in home country.
- No more than 50 per cent of the company's income is used to satisfy claims by other persons (i.e. interest, royalties, other fees)

A number of queries have been raised in relation to the questions. For example:

- Does an independent local board of directors with unfettered powers constitute management of the company?
- What is a sufficiently qualified employee? Does this require a certain number of employees to exist? Are directors employees?
- What is an active business? Would a holding company that has interests in numerous countries qualify? Pure holding companies are likely to be viewed as not having an active business.
- What is the position if an item of income is taxable but is then exempted by virtue of some specific provision? Does this mean the income is subject to tax?
- What does the 50% rule actually mean and how will it be applied? For example if the overseas company pays a dividend does this form part of the 50% amount? In our view it should not. What happens if the overseas company earns income in its own jurisdiction (e.g. interest income) - does this revenue also become part of the test or is it limited to Indonesian-sourced income?

The answers to these types of questions are not fully known at this stage and they need careful consideration when completing the form. Hopefully the ITO will provide more guidance on these points.

Banks – some points to think about.

Previously banks' CoDs were valid for an indefinite period of time. Under the new regulations a CoD will only be valid for twelve months.
What is a bank? The term "banking institution" is not clearly defined. We anticipate that banking institutions will need to hold some form of banking license issued by the relevant authority. Financial institutions will need to consider their respective position further if they wish to seek an annual CoD.

Share transactions on the Indonesian Stock Exchange – will the 0.1% tax still apply?

Transactions of shares on the Indonesian Stock Exchange are subject to a final tax of 0.1% based on the transaction value. Whilst it has always been arguable as to whether a tax treaty provides relief from this tax, in practice many taxpayers simply pay the tax. Arguably under the new regulations, no income tax should be due if a CoD is provided. However, at a practical level, it remains to be seen how the Indonesian Stock Exchange (through its brokers) may approach the issue, i.e. will they still require the 0.1% tax to be withheld?

What about branch profits tax – does a branch have to obtain a CoD from head office to enjoy a reduced treaty rate?

Most tax treaties provide for a reduced branch profits tax (where a treaty does not apply the rate is 20% - calculated on a profits after income tax basis). The tax is based on a deemed remittance of the after tax profits to the head office. In our view the new regulations are not targeted at branch profits tax, although the manner in which they are constructed means that branch profits could come within the new rules. Therefore a branch should get a CoD from the head office to ensure it can take advantage of the lower treaty branch profits tax rate.

Watch out for net of tax payments!

Many contracts with offshore parties are structured on a net of tax basis, i.e. the Indonesian payer bears the WHT cost. Given that it will now be much harder to obtain a CoD and meet the requirements, in the absence of a valid CoD being provided the Indonesian payer may find itself bearing additional WHT costs.

What should taxpayers be doing?

- Review what significant transactions you have with offshore parties where WHT may be due, particularly intercompany transactions.
- Consider your intercompany structure, for example is your parent company merely a conduit company or does it have substance? Should you be looking to reorganize the structure/substance?
- Review significant contracts with overseas parties to determine whether payments are payable on a net of tax or gross basis. Indonesian payers may find themselves with an additional cost if tax is payable on a net basis.
- Alert your regional/global tax team of the changes in the regulations.
- Advise overseas recipients of payments that unless they can provide the CoD 20% WHT will be deducted on payments.
- Payment recipients need to start planning to obtain a CoD.

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