

Singapore and Indonesia sign updated tax treaty

14 February 2020

In brief

On 4 February 2020, an updated tax treaty was signed between Singapore and Indonesia (referred herein as the “updated tax treaty”). Among other changes, the updated tax treaty introduces the following:

- Reduction in royalty withholding tax rate from 15% to 10%/8%
- Reduction in branch profits tax rate from 15% to 10%
- Inclusion of a capital gains tax article
- An anti-abuse provision based on the principal purpose test

The updated tax treaty has not been ratified by both countries to date and does not yet have the force of law.

In detail

A summary of the key changes to the tax rates in the updated tax treaty is as follows.

Type of income	Current treaty	Updated tax treaty
Dividends	<ul style="list-style-type: none">• 10% (subject to minimum 25% shareholding) or 15%	<ul style="list-style-type: none">• No change to tax rates
Branch Profits	<ul style="list-style-type: none">• 15%	<ul style="list-style-type: none">• 10%
Interest	<ul style="list-style-type: none">• 10% / 0% - certain instruments e.g. government bonds	<ul style="list-style-type: none">• 10% / 0% - limited to payment to government (as defined)
Royalties	<ul style="list-style-type: none">• 15%	<ul style="list-style-type: none">• 10% / 8% (depending on type of royalties)

Other key changes include:

Residency

The updated tax treaty introduces a third tie-breaker rule for individuals to be based on where the individual concerned is a national. This is consistent with the 2017 OECD Model Tax Convention.

As noted in the 1990 Protocol, when an agreement cannot be reached on the residency of a non-individual under Article 4(3), the taxable income of the relevant person shall be determined and agreed by the competent authorities, and one-half of such taxable income shall be taxable in each state. This understanding will continue to apply to the updated tax treaty (when ratified).

Permanent Establishment

A building site or construction, installation or assembly project constitutes a permanent establishment (PE) if it lasts more than 183 days. The updated tax treaty incorporates a time limit of three months for an assembly or installation project performed by a person other than the main contractor.

There is no change to the time test for services PE, which remains at 90 days, i.e. the furnishing of services will result in a PE if the activities continue in-country for more than 90 days within a twelve-month period.

Associated Enterprises

The updated tax treaty introduces a provision for corresponding adjustments in Article 9 (Associated Enterprises). This provision will not apply, however, where judicial proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.

Interest

The withholding tax exemption for interest arising from government bonds and paid to a resident of the other country has been removed from Article 11 (Interest) of the updated tax treaty. The definition of 'government' has been updated to include various government related financial institutions, for the purpose of the interest withholding tax exemption. The updated tax treaty also specifies that penalty charges due for late payment will not be regarded as interest.

Capital gains

The updated tax treaty has added Article 13 (Capital Gains), which is broadly consistent with the 2017 OECD Model Tax Convention.

Among other things, it cedes primary tax rights to the source state for gains from disposal of (a) immovable properties situated in the source state, and (b) non-listed shares in companies whose value are principally derived (directly or indirectly) from immovable properties situated in the source state, if the seller owns at least 50% of the shares in the company.

However, this provision does not extend to gains from disposal of shares (a) deriving their value from immovable property in which the company carries on its business, or (b) pursuant to a corporate reorganisation, merger or a similar restructuring activity.

Gains from the sale of shares in a company which is a resident of Indonesia and traded on the Indonesia Stock Exchange may continue to be subject to Indonesian final withholding tax.

Other than the above, the taxing rights over gains from disposal of shares belong only to the state in which the seller is resident.

Principal purpose test

The updated tax treaty added Article 28 (Entitlement to Benefits) - an anti-abuse provision based on the principal purpose test, which is in line with the mandatory provisions in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI).

The Inland Revenue Authority of Singapore (IRAS) has indicated in the circular entitled "Income Tax: Avoidance of Double Taxation Agreements (Second edition)" ([https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/e-Tax_Guides/etaxguide_Income%20Tax_Avoidance%20of%20Double%20Taxation%20Agreements%20\(DTAs\)_2nd.pdf](https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/e-Tax_Guides/etaxguide_Income%20Tax_Avoidance%20of%20Double%20Taxation%20Agreements%20(DTAs)_2nd.pdf)) that it must be reasonable to conclude that one of the main purposes of an arrangement or transaction was to obtain the benefits of the tax treaty in an improper and abusive manner before the principal purpose test is invoked to deny the treaty benefits. This is a question of fact and must be determined by carrying out an objective analysis of the aims of all persons involved, taking into account all facts and circumstances surrounding the arrangement or transaction. Taxpayers and investors with bona fide commercial transactions or operations should not be unduly concerned with the principal purpose test, which seeks to address abusive arrangements.

Force of attraction

Article 29(3) of the updated tax treaty retains the position in the current tax treaty, that Singapore will publicise the Indonesian position that business profits are subject to the Indonesian concept of "force of attraction of permanent establishment" principle with regard to PEs of residents of Singapore carrying on business in Indonesia, if requested.

Conclusion

Although there is no reduction to the dividend and interest withholding tax rates, nor lengthening of the 90-day services PE threshold, the introduction of a capital gains article and the corresponding adjustment provision for transfer pricing, along with other tweaks, should nonetheless be welcomed. The results of the updated tax treaty, when ratified and in force, should benefit businesses in both Singapore and Indonesia and continue to promote bilateral trade and investment flows between the two countries.

Let's talk for deeper discussion of how this updated tax treaty might affect your business, please contact:



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