royalties/FTS to 10%. However, the reduced rate under the tax treaties would still be beneficial due to the surcharge and education cess that is imposed under the ITA.

Exchange of information

The protocol provides, that on a request made by any state, the revenue authorities of the other state shall collect information that it is competent to obtain for its own purposes under its domestic laws and share the same through its competent authority.

Review of working of protocol

The protocol also provides for an intergovernmental group consisting of representatives of the revenue authorities of the two states, to review the working of the provisions of the protocol at least once a year or earlier at the request of either of the states. The group may make recommendations for improvements including improvements to the provisions of this protocol.

INDONESIA

Application of Interest Withholding Tax Exemption under Tax Treaty with the Netherlands Postponed*

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1. GENERAL BACKGROUND

The Indonesian Directorate General of Taxes (DGT) issued a Circular Letter on 1 June 2005[1] clarifying the treatment of Indonesian withholding taxes on interest payments under Indonesia's double taxation agreement with the Netherlands (DTA).[2]

The DGT is of the opinion that the exemption from Indonesian interest withholding tax, available under Art. 11(4) of the DTA,[3] cannot be applied as long as Indonesia and the Netherlands have not agreed upon implementation provisions. According to the DGT, in the meantime, the reduced Indonesian interest withholding tax of 10%, available under Art. 11(2) of the DTA,[4] must be applied.[5]

Pursuant to Art. 11(4) of the DTA, an exemption from Indonesian interest withholding tax applies if (i) the recipient is the beneficial owner of the interest,[6] (ii) this recipient is a resident of the Netherlands and (iii) the interest is paid (a) on a loan made for a period of more than two years or (b) in connection with the sale on credit of any industrial, commercial or scientific equipment.

Art. 11(5)[7] of the DTA provides that the two states will, by mutual agreement, settle the method of application of, inter alia, the exemption under Art. 11(4) as well as the reduced interest withholding tax rate of 10% under Art. 11(2).[8] As similar mutual agreement provisions in certain

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1. Circular Letter of the Indonesian Director General dated 1 June 2005, No. SE-17/PJ./2005 ("Circular Letter").
2. Agreement between the Government of the Kingdom of the Netherlands and the Government of the Republic of Indonesia for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, signed on 29 January 2002. The new DTA became effective on 1 January 2004.
3. Art. 11(4): "Notwithstanding the provision of paragraph 2, interest arising in one of the two States shall be taxable only in the other State if the beneficial owner of the interest is a resident of the other State and if the interest is paid on a loan made for a period of more than 2 years or is paid in connection with the sale on credit of any industrial, commercial or scientific equipment".
4. Art. 11(2): "However, such interest may also be taxed in the State in which it arises and according to the laws of that State, but if the beneficial owner of the recipient is a resident of the other State, the tax so charged shall not exceed 10 per cent of the gross amount of interest".
5. The Indonesian interest withholding tax rate for non-residents is, in principle, 20% (see IBFD, *Taxes and Investment in Asia and the Pacific*, Indonesia, p. 23, Suppl. No. 214 (June 2002)).
6. The DGT issued a further Circular Letter dated 7 July 2005 clarifying the relevance of "beneficial owner". In this Circular Letter, the DGT states that non-resident taxpayers, who are able to show a tax domicile certificate from a state that has concluded a tax treaty with Indonesia, are not automatically entitled to the reduced tax rates under the treaty and emphasized that non-resident taxpayers are only entitled to such reduced rates if they are the beneficial owners of the dividend, interest or royalty. The DGT clarifies that special purpose vehicles (e.g. conduit companies, etc.) are not included in the definition of beneficial owner, and if such companies receive interest, the Indonesian payor is obliged to withhold tax at the domestic rate of 20%. The question of whether a Dutch intermediary finance company is a conduit company for this purpose, will ultimately be a question for the Indonesian tax court and is beyond the scope of this article.
7. Art. 11(5): "The competent authorities of the two States shall by mutual agreement settle the mode of application of paragraphs 2, 3, and 4".
8. Such a provision is quite common and is normally invoked for the purpose of agreeing on reduction/refund procedures. A similar provision is also contained in Arts. 10(3) and 12(4) of the DTA. With respect to Art. 10(3), the Netherlands introduced general implementation provisions and forms that can be used to reduce Dutch withholding taxes on dividends payable to, inter alia, Indonesian taxpayers pursuant to two Decrees of the State Secretary of Finance dated 28 September 2004, No. IFZ2004/668 and No. IFZ2004/687.

other Indonesian DTAs have not led to the imposition of additional conditions for benefiting from these DTAs, we explained in our previous articles that additional conditions were not expected to be introduced.[9]

This article will summarize the main impact of the DGT's Circular Letter.

2. INDONESIAN CIRCULAR LETTER

The Circular Letter states that the DGT, as the competent authority of Indonesia, and the competent authorities of the Netherlands "... have not had any discussion regarding the implementation provisions".[10]

As to the reduced interest withholding tax rate of 10% under Art. 11(2), the DGT takes the view that "... no implementation guidelines are needed, because there is no problem in the implementation".[11]

As a consequence, Indonesian taxpayers are allowed to apply the reduced Indonesian withholding tax rate of 10% on interest payments to qualifying Dutch residents without awaiting any further governmental action.

The Netherlands normally allows a credit for the Indonesian withholding tax paid, if withheld pursuant to Art. 11(2) in conjunction with Art. 24(4) of the DTA.[12] This implies that the Indonesian withholding tax can be offset against the Dutch taxpayer's corporate or individual income tax liability.

As to the exemption under Art. 11(4), the DGT considers "... that no implementation guidelines have been discussed between the competent authorities of Indonesia and the Netherlands". The DGT is "therefore" of the opinion that the reduced Indonesian withholding tax rate of 10% applies and not the full exemption.[13]

It seems to us that in applying the 10% rate instead of the exemption, Indonesia is not acting in accordance with the DTA. By deferring the application of the exemption until the implementation provisions have been agreed upon, Indonesia is effectively introducing additional conditions. Furthermore, it is within Indonesia's own sovereign powers to implement the relevant provisions, which by their nature have an administrative character only.[14]

It is to some degree understandable that Indonesia desires to have implementation provisions available first, but then the exemption should be applicable retroactively. On the other hand, it can be questioned what kind of implementation provisions are needed, in particular since no implementation provisions are necessary for applying the 10% rate.

The Indonesian taxpayer could file an objection to the DGT's decision and, if unsuccessful, appeal the DGT's decision to the Indonesian tax court. However, these proceedings will not postpone the Indonesian taxpayer's obligation to pay the 10% Indonesian withholding tax.[15]

The Dutch taxpayer, on the other hand, could file a request to the Dutch Ministry of Finance (MoF) to start a mutual agreement procedure, pursuant to Art. 27(1) of the DTA, with the Indonesian DGT.[16] The Dutch MoF must, pursuant to Art. 27(2)[17] of the DTA, first be convinced that the objections are justified. The Dutch MoF is apparently already convinced of this, as it has informally confirmed that it initiated discussions with the DGT even before the issuance of the DGT's Circular Letter.[18]

General characteristics of a mutual agreement procedure are that (i) "... the competent authorities are under a duty merely to use their best endeavours and not to achieve a result",[19] and (ii) it is in practice time consuming (it may take many years).

Finally, it is questionable whether the Dutch taxpayer may credit the 10% Indonesian withholding tax against its Dutch corporate or individual income tax liability. It is the policy[20] of the Dutch Ministry of Finance not to allow such

9. According to an e-mail received from the Dutch MoF on 22 January 2004, the intention of both states is that the new implementing regulations should deal only with the procedure for refunding withholding tax and should not introduce additional conditions for applying the exemption. We also note that it would be unusual for new conditions to be laid down in the implementing regulations.
10. Unofficial translation of the relevant paragraph of page 1 of the Circular Letter.
11. Unofficial translation of the relevant paragraph of page 1 of the Circular Letter: "For the provision of Article 11 (2), no implementation guidelines are needed, because there is no problem in the implementation. An Indonesian taxpayer who has a loan from a resident of the Netherlands, whether individual or corporate, must withhold Income Tax under Article 26 at the rate of 10% from the gross interest paid".
12. For the conditions that Dutch finance companies must meet in order to use this credit, see "Indonesia: The New Income Tax Treaty with the Netherlands in Practice", para. 3.3, 10 *Asia-Pacific Tax Bulletin* 8 (2004) and "Indonesia: The Netherlands Finance Structure in Practice", para. 8., 10 *Asia-Pacific Tax Bulletin* 11 (2004).
13. Unofficial translation of the relevant paragraph of page 2 of the Circular Letter: "For the provision of Article 11 paragraph (4), considering that no implementation guidelines have been discussed between the competent authorities of Indonesia and the Netherlands, therefore, the provision as stated in point 1 above will prevail, that is an Indonesian taxpayer who has a loan from a resident of the Netherlands, whether individual or corporate, must withhold Income Tax under Article 26 at the rate of 10% from the gross interest paid".
14. See footnotes 8 and 9.
15. See IBFD, *Taxes and Investment in Asia and the Pacific*, Indonesia, p. 51, Suppl. No. 214 (June 2002).
16. Art. 27(1): "Where a person considers that the actions of one or both of the two States result or will result for him in taxation not in accordance with the provisions of the Agreement, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the State of which he is a resident ...".
17. Art. 27(2): "The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at an appropriate solution, to resolve the case by mutual agreement with the competent authority of the other State, with a view to the avoidance of taxation not in accordance with this Agreement".
18. Reference is made to a telephone conversation which the authors had with the competent department within the Dutch MoF on 22 June 2005. Pursuant to Art. 27(3), the Dutch MoF can start a mutual agreement procedure even in the absence of a specific case involving the interpretation of the DTA: "The competent authorities of the two States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of this Agreement. [...]"
19. Para. 26 of the Organisation for Economic Cooperation and Development (OECD) Commentary to Art. 25 "Mutual Agreement Procedure" of the OECD Model Tax Convention on Income and on Capital (OECD Model Convention). Art. 27 of the DTA is almost identical to Art. 25 of the OECD Model Convention. See also Chapter B. "Influence of the OECD Model Convention" Para. 12-15 of the Introduction to the OECD Commentary, Dutch Fiscal Treaty Policy 1987, Para. V.10. and "Indonesia: The Netherlands Finance Structure in Practice", Para. 3. and footnote 20, 10 *Asia-Pacific Tax Bulletin* 11 (2004).
20. This follows from para. 4.3.2.2.3. of the Dutch Fiscal Treaty Policy 1998 with respect to the limited offsetting possibilities for portfolio dividends and para. 6 of the Transfer Pricing Decree of the State Secretary of Finance dated 21 August 2004 No. IFZ 2000/680.

offsetting if, in its opinion, foreign withholding taxes have been wrongfully withheld.[21]

3. FINAL OBSERVATIONS

The exemption from Indonesian interest withholding tax has induced a number of Indonesian corporates to set up a Dutch intermediate finance company. However, as a result of the DGT's position, such Indonesian corporates (and other Indonesian taxpayers) now face an additional funding cost in the form of the 10% Indonesian withholding tax. According to the DGT's Circular Letter, this will apply at least until the relevant implementation provisions have been introduced.

Subject to the outcome of the discussions, which the Netherlands has started with Indonesia to resolve this issue, it is at this stage uncertain whether and, if so, when the exemption can be applied in the future. It is somewhat surprising that Indonesia and the Netherlands have misunderstood each other in this way with respect to the interpretation of the exemption.

Finally, it is noted that this development certainly does not contribute to Indonesia's international investment climate.[22]

21. A further question would be whether the Indonesian withholding tax can be deducted for Dutch corporate and individual income tax purposes. Pursuant to Art. 10(1)e of the Dutch Corporate Income Tax Act 1969 and Art. 3.14(7) of the Income Tax Act 2001 respectively, foreign taxes cannot be deducted from Dutch taxable income if, in short, there is a DTA with the source state. As the Netherlands has concluded a DTA with Indonesia, this deduction is in principle not allowed. In a decree issued on 21 June 1996 (No. IFZ 96/619), the Dutch State Secretary of Finance indicated that under certain conditions, a taxpayer may choose to apply a deduction instead of a tax credit even where a DTA is in effect. With respect to the 10% Indonesian withholding tax, however, the Dutch taxpayer may not be able to benefit from this decree, since it is questionable whether a tax credit would be available anyway.

22. With regard to similar issues relating to the investment climate in Indonesia, we refer to the petition dated 29 March 2004 filed by the US Securities Industry Association and the US-ASEAN Business Council, Inc. (copy available at www.sia.com/international/pdf/BoyceTriPolyta32904.pdf).

INDONESIA

Interpretation of the Term "Beneficial Owner" under Tax Treaties

The Director-General of Taxation has issued circular letter SE-04/PJ.34/2005 dated 7 July 2005 in which guidance is given on how the term "beneficial owner" should be interpreted under tax treaties entered into by Indonesia. According to the circular letter, the beneficial owner is the actual owner of the income in the form of dividend, interest and royalty.

The beneficial owner must be either an individual or a corporate taxpayer that is fully entitled to directly enjoy the benefits of the dividend, interest or royalty. Special purpose vehicles like conduit companies, paper box companies, pass-through companies, etc. are not considered to be the beneficial owner.

If the dividend, interest or royalty is paid to parties that are not considered beneficial owners, the payer is obliged under Art. 26 of the Income Tax Act to withhold income tax at a rate of 20% of the gross amount of the payment.