December 2018

Tax Alert

Changes to Indonesian Anti-tax treaty abuse rules

(DGT Regulation No 25/PJ/2018)

On 21 November 2018, the Director General of Tax (DGT) issued regulation No. PER-25/PJ/2018 ("PER-25") revising the anti-tax treaty abuse rules. The regulation is effective 1 January 2019. This regulation revokes the previous regulation No. PER-10/PJ/2017 ("PER-10") and is of importance to any non-Indonesian resident receiving income from Indonesia.

There are important changes to the administrative procedures for treaty relief, which should simplify compliance in future years.

However, there are also updates to the anti-abuse and beneficial ownership tests to be fulfilled by non-residents receiving Indonesian sourced income. These appear to create significant uncertainties in application of the rules in some cases. Failure to comply with the conditions in PER-25 means that the default statutory rules apply – e.g. withholding tax on payment for services, dividends, interest and royalties at the statutory rate of 20%.

Highlights of the new regulation – administrative issues

1. **The new regulation stipulates only one "Form DGT" for all non-Indonesian resident income recipients**

   The previous regulation required two types of Forms, being Form DGT-2 for non-resident banks, pension funds and parties receiving certain incomes from an Indonesian Custodian, and Form DGT-1 for other taxpayers. The abuse and beneficial ownership tests under the former Form DGT-2 were less stringent than for other taxpayers. The new regulation requires only one type of Form DGT for all types of non-Indonesian residents.

   Non-Indonesian banks and pension funds remain subject to less stringent tests, under part III of the new form, and as such this should be an administrative simplification. However, as discussed below, it appears that parties receiving income via Indonesian custodians, which were previously subject to the same less stringent tests are now subject to full anti-abuse rules – see further below.

2. **Submission channel for Form DGT**

   The Form DGT must now be submitted through electronic submission to the DGT's website, or a particular channel to be regulated by the DGT. This follows an overall shift by the DGT in favour of online filings.

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3. **Mechanism of submission and validation of Form DGT and Certificate of Residence ("CoR")**

The new regulation alters the mechanism for submission and validation of Form DGT and CoR as follows:

- The non-resident income recipient provides the Form DGT and Certificate of Residence (if required) only once to an Indonesian withholding tax ("WHT") agent in order to avail itself of the tax treaty benefit for the period stated in the Form DGT and Certificate of Residence. E.g. the WHT agent might be the first Indonesian counterparty potentially required to withhold once PER-25 takes effect.
- This particular WHT agent will then need to submit the information contained in the Form DGT or CoR into the DGT's website or other channels determined by the DGT and should receive an 'Electronic Receipt Note' from DGT which is to be sent to the non-resident income recipient.
- The Form DGT is valid for the period certified by the tax authority in the other jurisdiction (see further below) with a maximum validity period of 12 months, which may straddle the fiscal year.
- This 'Electronic Receipt Note' will then be shared with other Indonesian parties/WHT agents from whom the non-resident income recipient receives income.
- In the case the non-resident income recipient has transactions with multiple parties in Indonesia, it only needs to provide the 'Electronic Receipt Note' to the other Indonesian WHT agents for them to enclose it with their monthly tax returns in which the WHT on payment to such income recipient is withheld and reported.
- Prior to submitting it, the other Indonesian WHT agents must check the contents of the Form DGT and Certificate of Residence of such income recipient, which is available on the DGT's website, and assess whether the information fulfills the requirements under the prevailing regulation to be eligible for tax treaty benefits.

4. **Declaration of income earned for which tax treaty relief is claimed**

In the new Form DGT there is no requirement to declare the amount of income that is received from Indonesia. The same form will be reused over a period of up to 12 month period for all Indonesian payments to that non- resident income recipient.

5. **Changes to reasons for refunds of incorrectly withheld tax, including addition of Mutual Agreement Procedures ("MAP") outcomes**

The previous regulations provided for a refund mechanism, via the Indonesian WHT agent, in instances where:

- There is a misapplication of the tax treaty, or
- Form DGT-1 or DGT-2 is delivered after the Indonesian WHT agent has submitted its monthly withholding tax return for the relevant period.

The new regulation provides for a refund mechanism, in the event of:

- Misapplication of tax treaty – which among things includes administrative mistake, withholding error, typing error, or miscalculation of the tax withheld;
- Being late in fulfilling the administrative requirements for applying the tax treaty. That is, the administrative requirements are fulfilled after the Indonesian WHT agent has withheld the tax; or
- There is a Mutual Agreement between the competent authorities in Indonesia and the competent authorities of tax treaty partner countries based on mutual agreement procedures.

In addition, PER-25 clearly states that the refund can only be processed if the Indonesian WHT agent has previously reported the tax withheld in its WHT return for the relevant tax period.

6. **Potential ongoing difficulty for some jurisdictions on period of Form DGT and/or CoR coverage**

Some tax authorities may not be comfortable to validate the tax residency of taxpayers for future periods. This creates administrative difficulties in that the Form DGT and/or CoR effectively need to be reissued every month. It appears the new regulations do not resolve this problem as the validity of Form DGT is limited to the residency period certified by the tax authority in the other jurisdiction.

Highlights of the new regulation – eligibility issues

We expect the administrative changes set out above will be welcome news to many non- resident groups dealing with income flows from Indonesia. However, we note various wording changes have been made to parts of the regulations and the questions on the form, which will create uncertainty as to on-going eligibility for tax treaty relief post 1 January 2019.

7. Additional requirement of tax treaty abuse tests

The new regulation adds a new test to be passed in order to fulfill the tax treaty abuse test.

Article 5(1)(b) of the regulation requires that there is no arrangement of transactions either directly or indirectly with the objective to obtain benefits from implementation of double tax avoidance agreement, such as:

- Reduction of tax burden and/or
- double non-taxation in any country or jurisdiction;

which contradicts the purpose and objectives of double tax avoidance agreement. This is implemented in Form DGT as the new question 11 in Part V.

It is unclear if this is an attempt to replicate the principal purposes test (PPT) recommended under OECD BEPS action item 6, and contained in the multilateral instrument.

The new wording replaces a previous test which stated that abuse of a tax treaty occurs in the event that the main purpose or one of the main purposes of arrangement of a transaction is to obtain benefits of the tax treaty, and is contrary to the objectives and purposes of the entering into the tax treaty. However, the previous test could be interpreted as being satisfied if the other treaty abuse tests were met.

The new wording makes it clear that there is an overarching purpose test to be considered. We expect this mayl:

- lead to uncertainty in practice;
- require detailed consideration of the "purposes and objectives" of a treaty; and
- involve an interaction with the OECD multilateral instrument wording ("MLI"), under which the preamble wording of various Indonesian treaties is expected to change – potentially influencing the idea of what the purpose of a tax treaty is.

8. Other changes to treaty abuse tests

There are two other new and modified treaty abuse questions:

- The entity has relevant economic substance either in the entity's establishment or the execution of its transaction; and
- The entity has the same legal form and economic substance either in the entity's establishment or the execution of its transaction.

9. Change to Beneficial Ownership (BO) test on perceived conduit arrangements and income passed on by initial recipient in the form of dividends

In the previous regulations, one of the tests set in Form DGT-1 was that "no more than 50% of the entity's income is used to satisfy claims by other persons". This test is unchanged on the new Form DGT – see Part VI question 3. However, the previous regulation stated that the use of 50% of incomes which are used to meet the obligations shall not cover:

a. the granting of remuneration to employees which is given fairly in work relationship;

b. other costs commonly spent by the non-resident in carrying on its business; and

c. distribution of profits in the form of dividend to shareholders.

The new regulation does not include the dividend wording in point c above. As such, we expect questions will arise as to the eligibility of certain structures to access tax treaty benefits where an initial non-resident recipient of Indonesian income passes on funds in the form of dividends (or in combination with other items), being more than 50% of incomes, to its shareholders. It may also be that in most jurisdictions dividend can only be paid out of profits and the decision whether or not to pay dividend is discretionary and not mandatory, hence its exclusion from the new regulation.

10. Potential changes to treatment of income received via custodians

In the previous regulations, entities receiving incomes through Custodian in connection with incomes from transfer of shares or bonds which are traded or reported in a capital market in Indonesia, other than interest and dividend, could use Form DGT-2 and were subject to less stringent tests. This wording has been removed and such parties appear to now be subject to the full rules.

11. Change to declaration required to be made by Banks and Pension Funds receiving income – confirming status of beneficial owner

The new Form DGT includes an additional question in Part III, which is to be completed by Banking Institutions and Pension Funds receiving Indonesian income. It requires the bank or pension fund to confirm that the beneficial owner is not an Indonesian resident taxpayer and not a resident taxpayer of the country other than mentioned in Part I. In other words, they are required to confirm that the beneficial owner is a tax resident of the same jurisdiction as the bank or pension fund itself.

This is a significant change from the former Form DGT-2 wording (in Part II), which only required confirmation that the beneficial owner and the bank or pension fund were not Indonesian residents.

Banks and pension funds receiving Indonesian income should review this change carefully.

Requirements to be eligible for tax treaty benefits

The Indonesian WHT agent is required to withhold tax on the income derived by non-resident based on Indonesian Income Tax law. Such provision can be excluded and the provision under the tax treaty will apply, if:

- The provisions of the tax treaty differ from those of the Indonesian Income Tax Law
- The income recipient is not an Indonesian tax resident
- The non-resident income recipient is an individual or an entity who is a tax resident of the country under the concerned tax treaty
- The non-resident income recipient submits to the Indonesian WHT agent its certificate of domicile (i.e. Form DGT) that meets the administrative requirements (*see section 'Administrative requirements' below*).
- There is no tax treaty abuse (*see section 'No tax treaty abuse test' below*), and
- If the relevant tax treaty requires the non-resident income recipient to be the BO of the income, the BO requirements must be met (*see section 'Beneficial owner (BO) test' below*)

No tax treaty abuse test

Tax treaty abuse takes place when the main purpose or one of the main purposes of the transaction arrangement is to obtain tax treaty benefits and in contradiction with the purposes and intention of the tax treaty. In the view of the DGT, tax treaty abuse does not take place if all of the following conditions are fulfilled:

- If the non-resident income recipient is an individual, he/she does not act as an agent or nominee, or
- If the non-resident income recipient is an entity:
    a. There is economic substance in the establishment of the entity and execution of the transaction
    b. The legal form is the same as the economic substance in the establishment of the entity or the execution of the transaction
    c. The business activities are managed by its own management and the management has sufficient authority to carry out the transactions
    d. There are fixed assets and non-fixed assets (other than the assets generating income from Indonesia), which are adequate and sufficient to conduct business activities in that treaty country
    e. It has sufficient employees with the expertise and certain skills in accordance with its line of business,
    f. It has activities or an active business other than receiving income in the form of dividend, interest, royalty from Indonesia; and
    g. There is no arrangement of transactions either directly or indirectly with the objective to obtain benefits from implementation of DTA, such as
        - reduction of tax burden; and/or
        - double non-taxation in any country or jurisdiction;

        which contradicts the purpose and objectives of the double tax avoidance agreement.

In the event that there is a difference between the legal form or a transactional structure/scheme and the economic substance, Indonesian tax is applied in accordance with the applicable provisions based on substance over form as indicated in point (a) above.

Beneficial owner ("BO") test

In addition to the requirement the tax treaty abuse is not committed, in the case that the tax treaty requires the non-resident income recipient to be the BO of the income (for example interest, royalty and dividend income), the non-resident income recipient must certify that:

- If he is an individual, he does not act as an agent or nominee, or
- If it is an entity, it does not act as an agent, nominee, or conduit, and it must meet the following criteria:
    a. It has control in using or enjoying funds, assets, or rights that can generate income from Indonesia;
    b. Not more than 50% of the total non- consolidated income is used to fulfill obligations to other parties (these obligations do not include fair compensation payments to employees in relation to work, and payments to other parties for normal business costs);
    c. It bears the risks of assets, capital, and/or liabilities; and
    d. It does not have written or unwritten obligation to provide part or all of the income derived from Indonesia to another party.

Similar to PER-10 which the new regulation replaces, listed companies can no longer automatically qualify for tax treaty relief. They must satisfy all the tax treaty abuse and BO tests.

The administrative criteria – Form DGT

Administrative criteria to be fulfilled by the non- resident income recipient in order to apply the tax treaty are as follows:

- Using Form DGT;
- The form must be filled in correctly, completely and clearly by the non-resident income recipient;
- Signed by the non-resident income recipient or equivalent mark/ stamp as normally used in its country;
- Signed by the authorized official of the treaty country where the non-resident income recipient resides or equivalent mark/stamp as normally used in its country;
- There is a statement made by the non-resident income recipient stating that there is no tax treaty abuse;
- There is statement that the non-resident income recipient is the Beneficial Owner in case it is required by the tax treaty;
- Used for the period stated in the Form DGT; and
- The signing and marking by the competent tax authority officer must be done in Part II of the Form DGT.

The signing and marking by the competent officer in Part II of the Form DGT can be replaced by a standard Certificate of Residence ("COR") issued by that competent tax authority. Such COR must fulfill the following requirements:

- The document must use the English language;
- At least contains the information concerning the name of the non-resident income recipient, issuance date, and the applicable tax year; and
- Bears the name and signature of the authorized tax officer of the competent tax authority of the treaty country; or sign/stamp that is equal to the signature of the tax officer and the name of the tax officer as commonly used.

In the event the non-resident income recipient uses a COR, it must fill in the Form DGT except for Part II of the Form DGT.

Refund mechanism of tax that should not be payable

In the event of:

- Misapplication of DTA, due to administrative mistake; withholding error, typing error, and miscalculate the tax withheld,
- Late in fulfilling administrative requirements for applying DTA, i.e. the administrative requirements are fulfilled after the WHT agent has withheld the tax; or
- There is a Mutual Agreement between the competent authorities in Indonesia and the competent authorities of tax treaty partner countries based on MAP;

the non-resident income recipient may still be granted tax treaty benefits through the mechanism of restitution of overpaid tax that should not be payable through the Indonesian WHT agent. In addition, the tax refund can only be processed if the Indonesian WHT agent has reported the tax withheld in its WHT return for the relevant tax period.

COR and statement letter for foreign government entities, central banks and other entities expressly stated in the tax treaty

In the event that the non-resident income recipient is a foreign Government entity, central bank or other entity that is expressly stipulated in the tax treaty or as agreed by the DGT and the treaty country's tax authority, the application of tax treaty may be done without using Form DGT. However, such income recipient must furnish a COR issued by the competent tax authority, or a letter issued by the competent tax authority in its home country stating that the income recipient is exempted from tax in its home country pursuant to the tax treaty.

Verification by the Indonesian WHT agent

The Indonesian WHT agent must verify certain disclosures made by the non-resident income recipient in the Form DGT. Based on the verification conducted by the Indonesian WHT agent, the tax treaty benefits may or may not be applied. The tax treaty benefit can only be applied if the non-resident income recipient answers the questions in the Form DGT with the required responses – set out in the new regulation.

Transitional provision

The DGT Forms as prescribed by PER-10 remain valid until 31 December 2018.

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