SEPTEMBER 2015

COMMENTARY

Indonesia and the Netherlands Sign Protocol to Amend Existing Tax Treaty

On July 30, 2015, the Netherlands and Indonesia signed a protocol (the "Protocol") amending an 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, originally signed on January 29, 2002 (the "Tax Treaty").

The Protocol introduces, among other things, changes to the applicable withholding tax rates in respect of payments of dividends and interest. Notably, it also determines that terms not defined in the Tax Treaty, including the term "beneficial owner", are to be interpreted in accordance with the official commentary to the OECD Model Tax Convention on Income and on Capital (the "OECD Model Tax Convention"). These amendments are expected to have a significant impact on cross-border transactions involving Indonesian businesses, which are discussed in more detail in the final section of this *Commentary*.

The Protocol will come into force once both countries have finalized their respective ratification procedures, the timing of which is currently unknown.

Dividends

The Tax Treaty currently provides that withholding tax levied by the source state in respect of a dividend distribution made to a resident of the other state that qualifies as the beneficial owner of such dividend may not exceed 10 percent. The Protocol amends this as follows:

- A rate of 5 percent applies if the beneficial owner is a parent company and a resident of the other state which holds directly 25 percent of the capital of the company paying the dividends;
- A rate of 10 percent applies if the beneficial owner is a pension fund that is recognized and controlled according to the statutory provisions of one of the two states and the income of which is generally exempt from tax in the state according to whose statutory provisions it is recognized and controlled; and
- In all other cases, 15 percent.

Interest

The Tax Treaty currently provides that withholding tax levied by the source state in respect of a payment of

interest made to a resident of the other state that qualifies as the beneficial owner of such interest payment may not exceed 10 percent, albeit no withholding tax may be levied if the interest is paid either on a loan made for a period of more than two years, or in connection with a sale on credit of any industrial, commercial, or scientific equipment. The Protocol introduces a 5 percent withholding tax rate for such payments of interest in respect of which no withholding tax may be currently levied.

Beneficial Ownership

The Tax Treaty does not currently define or otherwise describe the term "beneficial owner". Whether the recipient of a dividend or interest payment is also the beneficial owner of such income is, however, a key consideration. Without beneficial ownership, a taxpayer will not be eligible for reduced withholding tax rates under the treaty.

The Indonesian tax authorities had previously published regulations, Regulation No. 62/PJ/2009 and Regulation No. 25/PJ/2010 (the "Indonesian Regulations"), which provide general guidelines regarding the application of Indonesian double taxation treaties with the aim of preventing treaty abuse. The Indonesian Regulations are used to assess whether a foreign recipient of income derived from Indonesian sources is considered the beneficial owner from an Indonesian perspective by reference to various criteria that differ depending on the wording of the treaty provision. The Indonesian tax authorities will apply such criteria where a foreign recipient claims a reduction of Indonesian withholding tax rates. Where the treaty requires the taxpayer to qualify as beneficial owner of an item of income, under the Indonesian Regulations the relevant recipient must be able to demonstrate that:

(I) It has not been established and/or the transaction structure is not solely intended to take advantage of tax treaty benefits;
(II) It has its own management to conduct its business activities and such management has sufficient authority to execute transactions;
(III) It has employees;
(IV) It is engaged in an active trade or business;
(V) It is subject to local taxation in respect of the Indonesian income; and
(VI) It does not use more than 50 percent of its total income to settle its obligations with third parties by way of interest, royalty, or similar payments.

The Indonesian Regulations provide further guidance as to whether an active trade or business is conducted within the meaning of (IV) above and details regarding the application of the test contained in (VI) above.

The Indonesian Regulations are relatively detailed and restrictive in comparison to the typical interpretation of beneficial ownership applied by most OECD member states, which generally refers to the official commentary to the OECD Model Tax Convention. The Protocol introduces a provision that requires the two countries to interpret provisions of the Tax Treaty that are identical or substantially similar to the provisions of the OECD Model Tax Convention in accordance with the OECD commentary. In particular, the Protocol provides that "the two States shall interpret the term 'beneficial owner' used in the Agreement in accordance with the interpretation thereof as published by the OECD at the moment of signing the Agreement and any subsequent clarifying modifications of such OECD interpretation". As a result, after ratification of the protocol we expect the Indonesian tax authorities to confirm that the Indonesian Regulations will no longer be the determinative source of guidance when assessing whether a Dutch resident is the beneficial owner of Indonesian sourced income for purposes of the Tax Treaty.

Implications

The Protocol ensures that the Tax Treaty will continue to facilitate Dutch investments in Indonesia and vice versa and importantly, investments into Indonesia by other foreign investors that have structured their investments or cross-border financing transaction through a Dutch resident company. From an Indonesian perspective, there are no bilateral tax treaties offering withholding tax rates that are as favorable as, or more favorable than, the rates contained in the Tax Treaty and the rates under the Protocol once ratified. The obligation on the two countries under the Protocol to interpret the treaty provisions in accordance with the OECD commentary, in particular with regard to beneficial ownership, is expected to reduce considerably the burden on qualifying Dutch residents to successfully claim reduced Indonesian withholding tax rates.

Cross-Border M&A and Investments. As a result of the reduced withholding rate on dividends for qualifying investments, the Protocol is expected to provide opportunities for the structuring of cross-border M&A transactions involving Indonesian businesses. Dutch or other foreign investors in Indonesian companies that have structured their investment as an equity stake held directly or indirectly through a Dutch resident holding company will see the efficiency of their structure enhanced by the new withholding tax rates on dividends. For instance, pension funds, which do not currently qualify as residents under the Tax Treaty as interpreted by the Indonesian Regulations for purposes of the reduced rate on dividends, would be eligible under the Protocol.

Cross-Border Financings. The Protocol is expected to enhance opportunities for cross-border financing transactions involving Indonesian businesses, despite the increase to 5 percent of the withholding tax rate for payments of interest that were previously exempt.

Noteholders typically require an issuer of debt securities to make additional payments to gross up for withholding tax on payments of interest. Indonesia currently imposes a withholding tax on payments of interest made by resident borrowers at a rate of 20 percent, which may be reduced under an available double taxation treaty depending on the eligibility for treaty benefits of each separate holder of securities. If debt securities are issued by an Indonesian issuer, noteholders typically require the issuer to make interest payments that are grossed up for the withholding tax leakage, which consequently increases the issuer's financing costs. To minimize the financing costs associated with tax gross-up amounts, several Indonesian businesses have issued debt securities indirectly through a Dutch subsidiary, which then lends the proceeds of the issuance to one of more of its Indonesian group companies by way of long-term intercompany loans. Under this debt issuance structure, Indonesian businesses are able to minimize financing costs in respect of gross-up amounts for tax. The Netherlands does not impose a withholding tax on payments of interest made by resident borrowers, including issuers of debt securities, and, subject to the relevant Dutch issuer being eligible for benefits under the Tax Treaty, payments of interest by the Indonesian group companies under the intercompany loans would benefit from the reduced Indonesian withholding rate.

While the zero percent withholding tax rate would no longer be available for payments of interest on such long-term intercompany loans, the obligation under the Protocol to apply the OECD commentary when assessing the beneficial ownership of the interest payments should provide more certainty regarding the application of the Tax Treaty. Consequently, the use of a Dutch vehicle for debt issuances will continue to be cost efficient and likely the best option available under Indonesia's double taxation treaties.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com/contactus/.

Paul C. Kuo
Singapore
+65.6233.5955
pkuo@jonesday.com

Michelle Angela
Singapore
+65.6233.5992
mangela@jonesday.com

Lodewijk Berger
Amsterdam
+31.20.305.4218
lberger@jonesday.com

Olaf Kroon
Amsterdam
+31.20.305.4262
okroon@jonesday.com

Blaise L. Marin-Curtoud
London
+44.20.7039.5169
bmarin@jonesday.com

Raymond J. Wiacek
Washington
+1.202.879.3908
rjwiacek@jonesday.com