

Client Update: Indonesia

3 August 2021

At Long Last, IND-SG Tax Treaty Tackles Capital Gains



On 11 May 2021, the new Indonesia-Singapore tax treaty was finally ratified by Indonesia under Presidential Regulation No. 35 of 2021. The new treaty will replace the previous treaty, which was effective for almost 31 years. In its official statement, the Directorate General of Tax stated that the treaty is meant to strengthen efforts to prevent tax evasion, protect, and increase Indonesia's tax base, and at the same, encourage increased investment from Singapore.

To sum up, there are three significant changes in the new treaty concerning tax treaty on dividends (branch profit tax) and royalties, all of which now enjoy a lower tariff, and new provision to provide capital gains tax protection. On the other hand, withholding tax on dividends and interests remain unchanged. We will discuss the changes in more details below.

Notable Changes

1. New provisions on capital gains

Spotlight is on capital gains as the new treaty introduces a standalone capital gains section that adopts the OECD Tax Convention Model. Previously, capital gains were not regulated despite the popularity of Singapore being used by investors to invest in Indonesia.

Indeed, many companies in Indonesia have a Singapore holding company, and a common scenario is the sale by that holding company of its shares in the Indonesian subsidiary. Under the old treaty, the Singapore shareholder will face a 5% withholding tax on the gross transfer value of unlisted shares. This 5% rate is the same rate imposed by Indonesia on holding companies from tax haven countries.

Taking the share transfer example above, in the new treaty, capital gains received by a Singapore shareholder in the sale of shares of an Indonesian company will most likely be taxed in Singapore, except if the sale involved shares in an Indonesian company where more than 50% of that company's value is derived from its immovable property **and** the selling shareholder owns more than 50% shares in such company **and**:

- (i) the shares are not traded in a stock exchange;

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- (ii) the sale was not conducted as a corporate reorganisation, merger, spin-off, or other similar restructuring; and
- (iii) the company's business is not conducted in the abovementioned immovable property.

Compared to the Malaysia-Indonesia tax treaty, which only requires the Indonesian company to satisfy the more than 50% (principally, to be exact) of the immovable property criteria, the Singapore-Indonesia treaty has a more restrictive requirement.

Meanwhile gains derived from the sales of ships or aircraft or moveable property pertaining to the operation of such ships or aircraft will be taxed to the state where the selling entity resides.

2. Reduced rate of branch profit tax ("BPT")

In the previous treaty, BPT was set at 15%. Now, the BPT provisions have been reformulated to become part of the provisions on dividend under Article 10(6) of the Treaty and prescribe a lower rate of 10%.

However, it is important to note that the new BPT rate does not apply to companies, other entities, residents of Indonesia or Singapore that are parties to a production sharing contract relating to oil and gas, and contract of works for other mining sectors. Additionally, the new treaty also erases the tax treatment provisions on Most Favoured Nation (MFN) towards Singaporean companies.

3. Exemption on interest for government, government issued bonds or debenture, and sovereign wealth funds

Generally, the provisions on interest remains the same as interest that may be taxed by the country where the interest recipient resides, which is a maximum of 10%.

However, the new treaty exempts government institutions of both countries and provides that interest received by any government institution in Indonesia or Singapore from government-issued bonds or debentures will enjoy a tax exemption. This exemption also applies to sovereign wealth funds, like GIC Private Limited and the newly established Indonesia Investment Authority, and their subsidiaries.

Additionally, the list for Indonesian government institutions includes the Indonesia Eximbank, Social Security Agency for Health (*Badan Penyelenggara Jaminan Sosial Kesehatan*) and Social Security Agency for Manpower (*Badan Penyelenggara Jaminan Sosial Ketenagakerjaan*), local public institutions, and any special-purpose investment entity established by the government (like the abovementioned sovereign wealth funds).

The new treaty also confirms that any penalty charge will not be regarded as interest under the definition of interest.

4. Reduced rate of royalties

Previously, royalty payments received a flat tax rate of 15%. Now, the treaty allows the 15% tax rate to be reduced as follows:

- (i) the use or the right to use any copyright pertaining to literary, artistic, or scientific work including cinematography film or tapes used for radio or television

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broadcasting, any patent, trademark, design or model, plan, secret formula or process will enjoy a 10% tax rate from the gross payment; and

- (ii) the use or the right to use any industrial, commercial, or scientific equipment, or information concerning industrial, commercial or scientific experience will enjoy a 8% tax rate from the gross payment.

5. **Annulment of provisions on the limitation of relief and the income not expressly mentioned**

The new treaty abolishes Articles 21 and 22 of the old treaty on the limitation of relief and the income not expressly mentioned and replaces them with Article 22 on other income which generally stipulates that income not dealt with in the new treaty shall be taxable only in the jurisdiction of residence.

6. **Exchange of Information (“EOI”)**

The new treaty also widens the provisions on EOI by adopting the OECD Model 2017. Now, any request for EOI by one country must be accommodated even if the requested information is not relevant for tax purposes. Further, there is no permission to decline the supply of information based on the reasons that the information is held by a bank, other financial institution, nominee, or a person acting in agency or a fiduciary capacity or ownership interest.

7. **New provisions on anti-tax avoidance**

Lastly, the treaty introduces a new anti-tax avoidance section under Article 28 of the Treaty. Under such Article, the benefit under the treaty will not be granted if one of the principal purposes of an arrangement or transaction is to obtain (whether directly or indirectly) the benefit under the treaty.

This is line with the stance adopted by Indonesia under Presidential Regulation No. 77 of 2019 on the Paris Multilateral Convention. The Convention contain similar provisions as the treaty under the principal purposes test, which is the method to assess possibility of treaty abuse, including through treaty shopping.

AHP’s Notes

For now, the treaty has not entered into force as Singapore also needs to ratify it. Afterwards, both countries must exchange the notification of the ratification documents for the treaty to enter into force. Then, the treaty will apply from 1 January of the following year.

We expect the renewed tax treaty to invigorate and deepened the flow of investments between Singapore and Indonesia. Investors are likely to view this new treaty positively. Singapore shareholders of Indonesian private companies will benefit from the capital gain tax protection under the new treaty for the conditions specified above. The reduced rate on BPT and royalties are some of the main attractions, especially for private equity houses and multinational corporations that depend heavily on their intellectual properties. Moreover, the law finally adopts a standalone capital gains tax provision and clarifies other points, including on interest, which will give more certainty in implementation.

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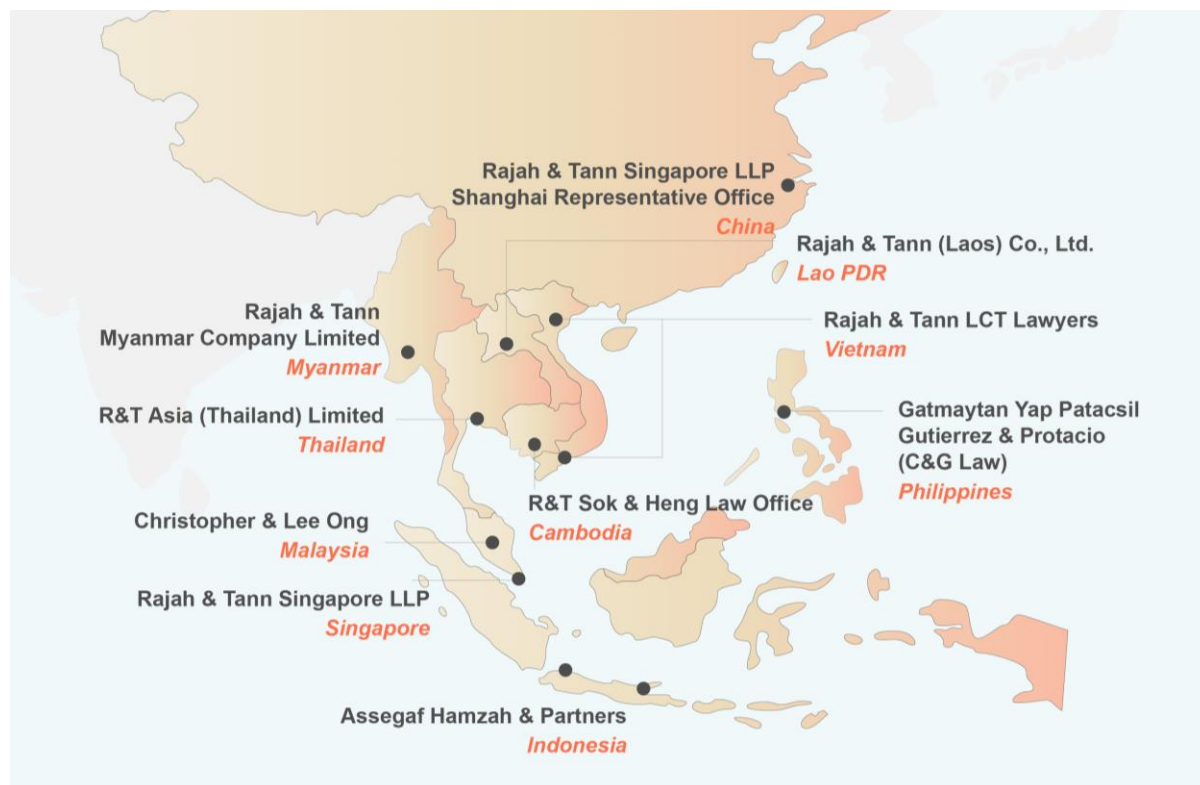
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