

How the Indonesia-Netherlands tax treaty enables tax avoidance

An analysis of the treaty and Indonesian court decisions on corporate tax disputes



Perkumpulan PRAKARSA & SOMO

August 2019

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Amsterdam, August 2019

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Abbreviations

APA	Advance pricing agreement
ATR	Advance tax ruling
BEPS	Base erosion and profit shifting
BIT	Bilateral Investment Treaty
BO	Beneficial Ownership
BPS	Badan Pusat Statistik (Central Statistics Bureau of Indonesia)
BPT	Branch Profit tax
BV	Besloten Vennootschap (Private Limited Company)
CPB	Centraal Planbureau (Bureau for Economic Policy Analysis)
CEPA	EU-Indonesia Comprehensive Economic Partnership Agreement
CGT	Capital Gains Tax
CIT	Corporate income tax
COD	Certificate of Domicile
CBS	Centraal Bureau voor de Statistiek (Central Statistics Bureau of the Netherlands)
CSP	Corporate Service Providers
DGT	Directorate General of Taxes (Indonesia)
DJP	Direktorat Jenderal Pajak (see DGT above)
DNB	De Nederlandsche Bank (Dutch Central Bank)
DR	Indonesia Rupiah (Rp)
DTA	Double Taxation Agreement
EU	European Union
FDI	Foreign direct investment
GAAR	General Anti-avoidance Rule
GDP	Gross Domestic Product
IBFD	International Bureau of Fiscal Documentation
IMF	International Monetary Fund
IP	Intellectual Property
LOB	Limitation on benefits
MAP	Mutual Agreement Procedure
MLI	Multilateral Instrument
MNE	Multinational Enterprise
MTI	Masyarakat Transparansi Indonesia (Indonesian Transparency Society)
NGO	Non-governmental organisation

ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
OFC	Offshore Financial Centre
PE	Permanent Establishment
PPT	Principal Purpose Test
PSC	Production Sharing Contracts
SLOB	Simplified limitation on benefits
SOMO	Stichting Onderzoek Multinationale Ondernemingen (Centre for Research on Multinational Corporations)
SPE	Special Purpose Entity
SPV	Special Purpose Vehicle
UN	United Nations
VCLT	Vienna Convention on the Law of Treaties
WHT	Withholding tax

Executive Summary

The double tax agreement between Indonesia and the Netherlands is being used, on a wide scale, for tax avoidance practices. More than 75 percent of the foreign direct investment from the Netherlands into Indonesia is structured via letterbox companies, signaling wide scale treaty abuse. The Indonesian tax authority (DGT) has been unable to, unilaterally, put a halt to practices of treaty abuse. This report unravels the weaknesses in the double tax agreement and explains why the Indonesian tax authority has been unable to deny the letterbox companies tax treaty benefits. The Indonesian tax authority has brought a number of tax cases before the Tax and Supreme Court, pleading companies' illegitimate use of tax treaty benefits. The Indonesian courts however, ruled in favor of the companies in most cases. This report analyses 27 of these cases, filed in the period 2010-2015 by the Indonesian tax authorities.

The most recent tax treaty between the Netherlands and Indonesia came into effect in 2002 and was amended in 2015. The Dutch tax treaty remained, after the 2015 amendments, one of the most favorable tax treaties of Indonesia due the inclusion of very low withholding taxes. Before the 2015 amendments the withholding taxes on dividends and royalties amounted 10% and for interest on specific loans only 0%. This latter withholding tax was raised to 5% with the 2015 amendments, while the withholding tax on dividends was divided between 5% (substantial holdings), 10% (pension funds) and 15% (portfolio). This makes the Dutch tax treaty one of the most favorable of the, in total, 68 tax treaties currently entered into by Indonesia. In comparison, only the withholding taxes on dividend payments (substantial holdings) of the Indonesian tax treaties with Kuwait, Saudi Arabia and the United Arab Emirates are as low as the Dutch tax treaty with Indonesia. Regarding interest payments on loans with a minimum term of two years only the Hong Kong's tax treaty with Indonesia has an equally low withholding tax. The highly favorable tax treaty benefits make the tax treaty between the Netherlands and Indonesia, in the words of Loyens and Loeff, one of the most attractive and competitive tax treaties entered into by Indonesia.¹ This is one of the most important reasons why the Dutch-Indonesian tax treaty has been utilized internationally, on a wide scale, for corporate tax avoidance structures.

The current withholding taxes, especially on interest payments of loans with a minimum term of two years and dividend payments related to substantial holdings, are very low. This is especially remarkable as the Netherlands has promised, as put forward in its circular on Dutch tax treaty policy from 2011, to offer developing countries relatively higher withholding taxes.² It is therefore highly remarkable that the tax treaty between the Netherlands and Indonesia is one of the most favorable in terms of low withholding tax rates.

1 Loyens & Loeff (5 July 2017). "Revised Netherlands-Indonesia Tax Treaty becomes effective on 1 October 2017", news article. URL: <https://www.loyensloeff.com/en-us/news-events/news/revised-netherlands-indonesia-tax-treaty-becomes-effective-on-1-october-2017>

2 Rijksoverheid, 'Notitie Fiscaal Verdragsbeleid 2011' 11 February 2011, https://www.eerstekamer.nl/behandeling/20110211/_fiscaal_verdragsbeleid_nfv

Furthermore, the Dutch-Indonesian tax treaty has no anti-abuse measure. This makes it difficult for the Indonesia tax authority to deal with cases of tax treaty abuse. In order to tackle treaty abuse the concept of 'beneficial ownership' has been included in the 2002 Dutch-Indonesian tax treaty. The Dutch and the Indonesian government formally agreed in the tax treaty that 'the competent authorities of the two States shall by mutual agreement settle the mode of application'. This agreement was however never reached. The Indonesian government tried to solve this problem unilaterally by implementing a unilateral definition of beneficial ownership, through a so-called 'Circular Letter'.³ These unilateral measures were, according to the Indonesian Supreme Court and the Netherlands, to be considered a treaty override. Foreign investors in Indonesia that receive, for example interest, and want to make use of the tax treaty benefits with the Dutch DTA have to show to the Indonesian tax authority that they have fiscal domicile in the Netherlands and that the recipient is the beneficial owner. Whenever these requirements are not fulfilled tax treaty benefits will be denied. The Indonesian interpretation of 'beneficial ownership' status in the Netherlands for the analyzed 27 cases, is based upon the Dutch substance requirements that apply to so-called 'Intermediary Finance Companies' that were updated in 2004, 2014 and 2018.⁴ It became apparent, by analyzing the 27 court cases, that letterbox companies could easily fulfil those substance requirements.

This report shows the reasons for the wide scale treaty abuse of the Dutch-Indonesian double tax treaty. It is especially due to the low withholding taxes of the tax treaty as well as the low substance requirements for letterbox companies in the Netherlands that over 75% of the FDI from the Netherlands in Indonesia is structured via letterbox companies. This leads to a substantial loss in tax revenue for the Indonesia society as the Netherlands is one of the biggest investors in Indonesia. It is unclear whether the Dutch or the Indonesian government pressured for the low withholding rates in the tax treaty. Nonetheless, the Dutch government, as a capital exporting country, should offer the Indonesia government more taxation rights, by pleading to increase the withholding tax rates as applicable in the current tax treaty. Especially the low withholding tax of 5% on dividends (substantial holding) and interest⁵ has to be increased. A second important aspect of treaty abuse are the substance requirements, for example relevant for Dutch holding companies in international structures and Dutch financial services companies. Those substance requirements are rather weak and facilitate the role of the Netherlands as conduit country for international companies.

3 Orbitax (2005). Indonesia – Netherlands. URL: <https://www.orbitax.com/news/archive.php/The-Indonesian-Director-Genera-964>

4 Ministry of Finance (2014). Dienstverleningslichamen en zekerheid vooraf. Lichamen met financiële dienstverleningsactiviteiten binnen concernverband zonder reële economische aanwezigheid in Nederland; geen zekerheid vooraf, verstrekken van inlichtingen en beperking verrekening bronheffing. Besluit DGB 2014/3101. URL: <https://zoek.officielebekendmakingen.nl/stcrt-2014-15957.html>; Ministry of Finance (2018). Wijziging van de Wet op de dividendbelasting 1965, de Wet op de vennootschapsbelasting 1969 en enige andere wetten in verband met de introductie van een inhoudingsplicht voor houdstercoöperaties, de uitbreiding van de inhoudingsvrijstelling in de dividendbelasting en wijziging van enkele antimisbruikbepalingen in de dividendbelasting en vennootschapsbelasting (Wet inhoudingsplicht houdstercoöperatie en uitbreiding inhoudingsvrijstelling). URL: <https://www.rijksoverheid.nl/binaries/rijksoverheid/documenten/kamerstukken/2017/09/19/wet-inhoudingsplicht-houdstercoöperatie-en-uitbreiding-inhoudingsvrijstelling-memorie-van-toelichting/Wet+inhoudingsplicht+houdstercoöperatie+en+uitbreiding+inhoudingsvrijstelling+-+Toelichting.pdf>

5 Related to loans made for a period of more than 2 years or paid in connection with the sale on credit of any industrial, commercial or scientific equipment.

The proposal⁶ by the Dutch government to require taxpayers that want to obtain a ruling to have an 'economic nexus' in the Netherlands, is a small but necessary step forward.

Both the Netherlands and Indonesia have signed the Multilateral Instrument (MLI), though it still has to be ratified by Indonesia. The MLI contains anti-abuse measures that has the potential to limit tax treaty shopping. Through the ratification of the MLI by Indonesia the Principal Purpose Test will become effective. It remains to be seen to what extent this anti-abuse measure will be able to limit the treaty abuse of the tax treaty between the Netherlands and Indonesia. The inclusion of an additional anti-abuse measure, the 'Simplified Limitation on Benefits', is strongly recommended. It is however clear, that additional domestic legislation is necessary to challenge the abuse of the Dutch-Indonesian tax treaty, both in the Netherlands and in Indonesia. Indonesia should review all tax treaties with countries that have offshore financial centers and/or high amounts of FDI going into Indonesia, and renegotiate these where necessary. The government must also strengthen the capacity and position of both the tax authority and the tax court.

6 Ministry of Finance (2019). Kamerbrief beleid vernieuwde rullingpraktijk. URL: <https://www.rijksoverheid.nl/documenten/kamerstukken/2019/04/23/kamerbrief-beleid-vernieuwde-rullingpraktijk>

1 Introduction

“‘Treaty shopping’ – the use of tax treaty networks to reduce tax payments – is a major issue for many developing countries, which would be well-advised to sign treaties only with considerable caution.”

International Monetary Fund (IMF), 2014⁷

There is a growing body of research on the negative impacts that economic treaties have on low and lower middle-income countries. Trade and investment treaties restrict a country’s policy space to pass legislation in the public interest, and safeguard revenues and human rights *vis-à-vis* (foreign) investor rights. This is true in the case of the EU-Indonesia Comprehensive Economic Partnership Agreement (CEPA), for instance.⁸

As the IMF quote cited above indicates, there is increasing recognition among policy makers and academics that bilateral taxation treaties have a negative impact on signatory states, in particular the domestic revenue mobilisation of developing countries. Dutch tax treaties have a special role in stimulating treaty shopping through the undue granting of preferential rates to foreign or domestic investors that set up letterbox companies in the Netherlands solely to gain access to these treaty benefits.

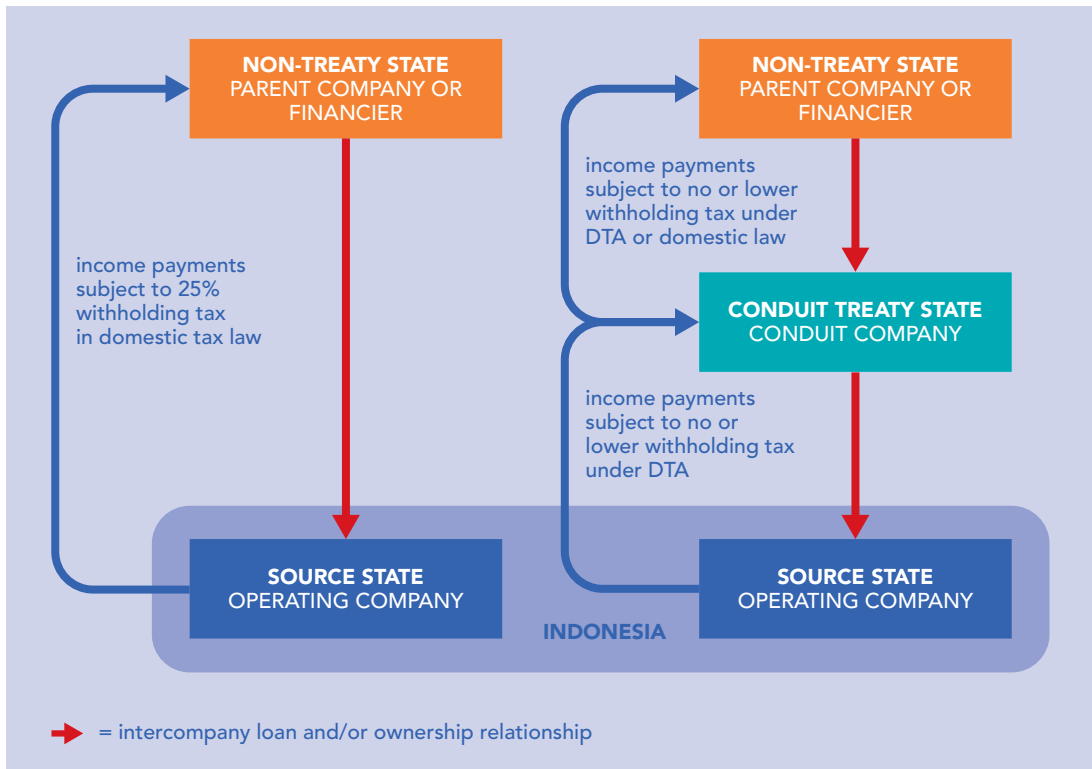
By routing investment or financing through a Dutch conduit rather than directly, investors and creditors can avoid Indonesian domestic taxes because they qualify for lower taxes under the Indonesia-Netherlands double taxation agreement (from here on referred to as DTA or tax treaty).

Treaty shopping typically involves attempts by companies that are residents of third states (such as the United States) or even source states (Indonesia), to access indirectly and unduly the benefits of a treaty between two contracting states (such as Indonesia and the Netherlands, via the Indonesia-Netherlands DTA). In the case of Indonesia, such cases may also see an Indonesian resident company seeking to obtain treaty benefits through a transfer of tax residence to the Netherlands or through the use of an entity established in the Netherlands that can access treaty benefits.

7 International Monetary Fund (May 2014). Staff Report on Spillovers on International Corporate Taxation, <https://www.imf.org/external/np/pp/eng/2014/050914.pdf>, p. 24.

8 IGJ, SOMO, TNI (September 2017). Human Rights as a Key Issue in the Indonesia-EU Comprehensive Economic Partnership Agreement, <https://www.somo.nl/wp-content/uploads/2017/09/Briefing-paper-CEPA.pdf>

Figure 1 Simplified treaty shopping scenario



Source: authors

A number of developments have stimulated the increase in treaty shopping, notably the rise of e-commerce, digitalisation and globalisation alongside the prevalence of nation based tax systems. Tax treaties were often negotiated and entered into force when investments were conducted with ‘brick-and-mortar establishments’. Legal entities today, however, can be set up at low cost, without the need for a physical presence, within a day, and financial transactions between them are also conducted at high speed and low cost. Because policy has not adapted to these developments, loopholes emerged in tax treaties. These loopholes, together with deliberate or non-deliberate policies that have enabled business to be conducted without restrictions and at low taxation, have led to widespread treaty abuse and massive revenue losses for states and public finance around the world. Whilst tax policies and treaties enable income to be shifted between jurisdictions at low or no taxation, corporate law also promotes setting up and disbanding companies at low cost and without the need for transparency, physical presence, or legal liability for beneficial owners (the concept of ‘beneficial ownership’ will be defined in chapter 3 of this report). This allows corporations to use a global network of jurisdictions in their tax minimisation structures.

In a forthcoming Prakarsa and SOMO briefing, two case studies will show how Indonesian companies use Dutch letterbox companies to avoid withholding taxes (WHT), and corporate income tax (CIT) on profits (including capital gains from the sale of shares) in Indonesia. More than 75 per cent of the foreign direct investment by the Netherlands in Indonesia is related to letterbox companies. This leads to substantial tax revenue losses for Indonesian society as the Netherlands is the second biggest investor in Indonesia.⁹

This report provides a literature review and analysis of tax disputes between the Indonesian Directorate General of Taxation (DGT) and corporate taxpayers that have come before the Indonesian Tax Court and Supreme Court. The report highlights a number of critical issues in the Indonesia-Netherlands tax treaty which enable companies to use the treaty to set up tax avoidance structures. This report concludes that in order to combat these tax dodging structures, strong anti-abuse provisions need to be included in the treaty.

9 In 2017, the Dutch-owned FDI stock in Indonesia amounted to US Dollars (USD) 43.7 billion (Singapore leading with USD 58 billion and the United States being the third biggest with USD 24 billion). Based on IMF – CDIS data: <http://data.imf.org/?sk=40313609-F037-48C1-84B1-E1F1CE54D6D5&slid=1482331048410>, accessed 22 January 2019.

2 Research methodology

It is in the interest of Indonesian citizens to ask whether Indonesian government policies, including bilateral treaties such as DTAs, serve Indonesian development. This report by SOMO and Perkumpulan Prakarsa aims to answer this question with a literature overview, and an analysis of judicial decisions on tax disputes regarding treaty shopping brought by the Indonesian revenue authorities and taxpayers to the Indonesian Tax Court and Supreme Court.

The main aim of this report is to inform Indonesian civil society organisations about their country's tax treaty system and how it impacts public revenues in Indonesia, and suggest policy reforms to protect the Indonesian tax base and the much-needed financing of public services in Indonesia. The report furthermore aims to create space for lobby and advocacy activities around the area of corporate taxation. The executive summary of this report is also available in Bahasa.

To provide policy context to the analyses presented in this report, it also provides an overview of existing literature on tax treaties and the impact of these treaties for net capital-importing states such as Indonesia as well as an explanation of how the Dutch fiscal regime creates tax losses in other countries. The impact of the Indonesia-Netherlands DTA on Indonesian revenue is partially quantified on the basis of Indonesian Tax Court cases, the above-mentioned individual case studies and existing estimates by other authors.

Cooperation Prakarsa and SOMO

This report is the product of the partnership between Perkumpulan Prakarsa, based in Indonesia, and SOMO, based in the Netherlands. The expertise of Prakarsa on tax issues in Indonesia and the experience of SOMO with corporate tax avoidance research made for a complementary partnership. The two organisations began their cooperation on this report in 2016. The objective was to investigate the abuse of the Netherlands-Indonesia tax treaty, so civil society organisations in Indonesia, the Netherlands and elsewhere could use this as evidence to advocate for policy changes to address treaty abuse. While work on this report began in 2016, due to the complexity of the subject matter and personnel changes at Prakarsa and SOMO, the report is published in 2019. A forthcoming briefing by Prakarsa and SOMO will provide two additional case studies like the one presented in chapter 7 on Indosat.¹⁰

The cooperation between Prakarsa and SOMO came to fruition due to the alliance between SOMO and Oxfam Novib in the Netherlands, as Prakarsa has for a number of years been a partner of Oxfam Novib. Prakarsa, Oxfam Novib and SOMO have also organised training courses in Indonesia in 2017 and 2018. These courses were aimed at strengthening the research and advocacy capacity of civil society organisations from across South-East Asia on the topic of tax avoidance, as well as contribute to the cooperation between participating organisations. This report, as well as these training courses, are made possible by the joint Oxfam Novib and SOMO project 'Strategic Partnership on Greater Responsibility in Finance for Development', funded by the Dutch Ministry of Foreign Affairs.

¹⁰ For further information please contact the authors.

This project aims to strengthen the power of civil society organisations to promote fiscal and financial justice, monitor government spending, and hold governments, the private sector and international institutions to account. SOMO and Oxfam Novib are members of the Tax Justice Netherlands network.

Methodology and limitations

This study uses the Indonesia-Netherlands DTA as an example of a DTA between a developing and a developed country. Firstly, we will identify patterns of use and abuse of the DTA by companies, and secondly, estimate typical revenue losses for a developing country like Indonesia because of the tax treaty abuses identified in the review of court cases. This study will complement previous studies¹¹ and IMF reviews of DTAs.¹²

This research is qualitative in nature, with quantitative data used to enrich the analysis. Most of the secondary data used includes laws, regulations, court decision files, and annual reports. Interviews were also held with key informants from the Indonesian Ministry of Finance, the Directorate General of Taxes (DGT), and with a Supreme Court Judge to review the findings and enquire about recent policy developments.

As mentioned above, the report uses the Indonesian tax court cases as data source. This report contains an overview of 27 tax disputes lodged at the Tax Court and the Supreme Court regarding the application of the Indonesia-Netherlands DTA.

Data gathered for this study includes decisions made in the Tax Court concerning tax disputes on the Indonesia-Netherlands DTA, administrative appeals at the level of the Tax Court, and appeals for judicial review decided on by the Supreme Court. Decisions of both the Tax Court and the Supreme Court have a binding or final legal force.

All decisions were taken from the directory website of the Supreme Court decisions of the Republic of Indonesia (which includes Tax Court decisions),¹³ and collected within three months (23 June 2016 until 31 August 2016). Because the directory website of the Supreme Court decisions does not classify the tax disputes, a total of 7,460 tax dispute decisions were downloaded and scrutinised for a final selection of the disputes.

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- 11 SOMO (2013). 'Should the Netherlands sign tax treaties with developing countries?', SOMO, June 2013. Rahayu, Ning (2008) Praktik Penghindaran Pajak (Tax Avoidance) Pada Foreign Direct Investment Yang Berbentuk Subsidiary Company (Pt. Pma) Di Indonesia (Suatu Kajian Tentang Kebijakan Anti-Tax Avoidance) [Tax avoidance practices of foreign direct investors through subsidiary companies (PT PMA) in Indonesia. A review of Indonesia's anti-tax avoidance policy], Doctoral dissertation, University of Indonesia, Faculty of Social Science and Political Science, FISIP UI. Rahayu, Ning (2010) Evaluasi Regulasi Atas Praktik Penghindaran Pajak Penanaman Modal Asing [Evaluation of the regulation to prevent tax avoidance by foreign investors], *Journal of Accounting and Finance Indonesia*, June 2010, Vol. 7, No. pp. 61-78. Hearson, Martin (2016). Measuring Tax Treaty Negotiation Outcomes: the ActionAid Tax Treaties Dataset, ICTD Working Paper 47, <http://www.ictd.ac/publication/2-working-papers/99-measuring-tax-treaty-negotiation-outcomes-the-actionaid-tax-treaties-dataset>, pp. 13-14.
- 12 IMF (2012). Mongolia: Technical Assistance Report – Safeguarding Domestic Revenue – A Mongolia DTA model. IMF Country Report No. 12/306. URL: <https://www.imf.org/external/pubs/ft/scr/2012/cr12306.pdf>
- 13 See website of the "Directory of the Supreme Court of Republic of Indonesia tax authority", <http://putusan.mahkamahagung.go.id/>

The selection criteria for this study were firstly, that the dispute should concern the application of the Indonesia-Netherlands DTA and, secondly, that a final decision had been made on the case. This resulted in a final list of 27 cases; of these, 11 final decisions were made through an appeal decision in the Tax Court and 16 from judicial review in the Supreme Court (see Table 6).

Analysis was guided by the following questions:

1. What are the typical cases brought before the Indonesian Tax Court regarding foreign Dutch residents and what are the company structures identified by the Indonesian Tax Authorities?
2. What are the typical decisions on tax dispute cases where companies have used the Indonesia-Netherlands DTA to avoid tax payments?

One limitation of this research is that by using company data at the subsidiary level, calculations of revenue losses are case-based rather than systematic and assume that the cases brought forward by the DGT were genuine treaty shopping cases, even if the case was lost in the courts.

Because only tax disputes relevant to the Indonesia-Netherlands DTA were analysed, not all common treaty shopping methods are identified in this report. Any report on such methods would require a closer look at treaty disputes related to other common treaty shopping countries, notably Singapore. Karyadi & Darussalam, for instance, provide a more general overview of Indonesian treaty disputes, and identify issues such as the definition of permanent establishment in relation to the taxation of active income in articles relating to shipping (Singapore treaty) or the classification of technical service fees and its impact on source taxation (Japan treaty).¹⁴

The recommendations provided in Chapter 8, therefore, do not cover all aspects of the Indonesian treaty network. An effective reform of Indonesia's tax treaty policy to protect source taxation and tackle treaty shopping would require a more in depth analysis of the treaty network.

Review procedure

Draft versions of this report have been shared with various stakeholders, at various stages of the research process:

- **Government institutions:** The draft versions of this report haven been shared both with the Dutch Ministry of Finance as well as the Indonesian Directorate General of Taxes and the Indonesian Ministry of Finance for feedback. Their useful comments have been integrated in the report.
- **Experts:** A number of experts have also commented on draft versions of this report, including Martin Hearson (Institute of Development Studies), Geerten Michielse (Professor in Tax Law), Rachel Saw (IBFD, Asia Division), Bart Kosters (IBFD) and Francis Weyzig (Oxfam Novib).

14 Karyadi, Freddy & Darussalam (2017) Tax Treaty Disputes in Indonesia, in E. Baistrocchi (Ed.), A Global Analysis of Tax Treaty Disputes (Cambridge Tax Law Series, pp. 1234-1282). Cambridge: Cambridge University Press.

- One specific company case (chapter 7) was researched in-depth to illustrate the specific mechanisms used for tax avoidance in relation to the Dutch-Indonesian tax treaty. As part of SOMO's internal quality assurance policies, reports are published or shared with external parties only after the investigated company has had the opportunity to respond to research findings. The company, PT Indosat Tbk was twice given the opportunity to review to the research findings and correct any factual errors, in January 2018 and in April 2019.¹⁵ Indosat however did not respond to repeated requests by SOMO.

Structure

Chapter 3 explains in more detail how tax treaties work and how they are related to economic justice and fair taxation in Indonesia. The chapter looks at revenue generated by the taxation of corporate income in Indonesia and provides an overview of findings in the literature on tax avoidance structures through treaty shopping, particularly using the Indonesia-Netherlands DTA.

Chapter 4 provides insight into why such a small country as the Netherlands is one of the world's biggest foreign investors. It explains the disproportionate amount of Dutch in- and outward investments (measured in FDI) in relation to the country's economic output (measured in Gross Domestic Product, or GDP). Flows of FDI through letterbox companies based in the Netherlands have increased by 75 per cent since the beginning of the financial crisis in 2008.¹⁶ The chapter goes on to explain the policies in domestic tax and corporate law (such as loose substance rules, tax rulings, participation exemption, no WHT on outgoing payments) that enable Dutch conduit structures,¹⁷ and the Dutch tax treaty policy and network.

Chapter 5 describes and analyses the changes in the Indonesia-Netherlands DTA since it was first signed in 1973 until now (Chapter 5.1) as well as Indonesia's tax law and court system (Chapter 5.2). So far, there have been four amendments (including one termination and full renegotiation) of the treaty, referred to here as DTA 1973, DTA 1993 (the 1991 Protocol is not included here), DTA 2002, and the most recent amendment by a Protocol, DTA 2015. The cases presented in this report cover the period 2003 - 2015, during which time the DTA 2002 was applicable. This section also discusses the DTA 2015 amendments, which importantly increase the WHT on interest on loans, with a term of more than two years or loans related to sales credit of industrial, commercial or scientific equipment, from zero per cent to five per cent thus somewhat improving source taxation rights, but failing to address other problems identified in the tax dispute analysis.

15 The two time periods (January 2018 and April 2019) do diverge substantially because the researchers, both from SOMO as well as Prakarsa, that initially started this project, did leave prematurely.

16 Dutch efforts to combat letterbox companies have no effect (SOMO, March, 2018)
<https://www.somo.nl/dutch-efforts-combat-letterbox-companies-no-effect/>

17 The current Secretary of State of Finance has outlined his ambition to implement a conditional withholding tax on royalties and interests (from 2021 onwards). However, the conditional withholding tax will only be applicable towards so-called 'low-tax jurisdictions' and countries on the EU blacklist of non-cooperative tax jurisdictions. Indonesia will therefore fall out of the scope of this, planned to be introduced, conditional withholding tax.

Chapter 6 discusses disputes between taxpayers and the Indonesian Tax Authority on the basis of 27 Tax and Supreme Court case decisions and exposes a number of problems in the application of the treaty and Indonesian tax law that are currently leading to the continued use of Dutch conduit entities by foreign and Indonesian businesses to avoid taxation in Indonesia. The barriers identified to the tax authorities successfully challenging undue granting of treaty benefits to taxpayers do not only concern treaty shopping. It also raises general questions as to the allocation of taxing rights between Indonesia as a net capital receiving and the Netherlands as net capital exporting state in the bilateral treaty.

Chapter 7 presents a case of a company using the Netherlands-Indonesia tax treaty to avoid taxes in Indonesia. Chapter 8 presents conclusions and policy recommendations for Dutch and Indonesian policy makers.

3 Tax treaties and tax avoidance in Indonesia

“The staggering proliferation of tax treaties [...] has sometimes been celebrated as indicative of their success. The tragedy for low-income countries is that the success of the high-income states in negotiating ever more treaties has come at the expense of the tax revenue bases of low-income countries. These treaties may be a true ‘poisoned chalice’ for developing countries, perversely transferring tax revenue from low-income countries to high-income countries (and from low-income countries to multinationals) while yielding limited or no offsetting benefits such as increased foreign direct investment.”

Brooks & Krever, 2015¹⁸

This chapter explains in more detail how tax treaties work and, in particular, their relationship to economic justice and fair taxation in Indonesia. It examines revenue generated from the taxation of corporate income in Indonesia by the economic sector, and provides an overview of findings in literature on tax avoidance structures through treaty shopping, particularly those using the Indonesia-Netherlands DTA.

3.1 Tax treaties and the need for reform

Although tax treaties have initially been designed to prevent double taxation they often lead to the very opposite, double non-taxation. For a number of years now, academics¹⁹ and non-governmental organisations (NGOs)²⁰ have been arguing for a fundamental reform of the tax treaty system.

18 Brooks, Kim & Rick Krever (2015). The troubling role of tax treaties in Michielse, Geerten; Thuronyi, Victor (eds.), Tax Design Issues Worldwide, Kluwer Law International, p. 160.

19 See volume edited by Lang et al. (2010). Tax Treaties: Building Bridges between Law and Economics, IBFD, Amsterdam. In particular contributions by Victor Thuronyi, Tax Treaties and developing countries, pp. 441-455 and Pasquale Pistone, Tax Treaties with developing countries: a plea for new allocation rules and a combined legal and economic approach, pp. 413-439. See also Eduardo Baistrocchi (2008) The use and interpretation of tax treaties in the emerging world: Theory and implications, in British Tax Review, Issue 4, 352-391 and more recently, the volume edited by Geerten Michielse and Victor Thuronyi (2015) Tax Design Issues Worldwide, Kluwer Law International, especially Brooks, Kim and Krever, Rick, The troubling role of tax treaties, pp. 160-161.

20 ActionAid has published a number of excellent case studies and in 2016 an analysis of the content of the negotiated texts of 519 tax treaties of 60 sample countries in sub-Saharan Africa and Eastern and Southern Asia. Indonesia and India were unfortunately not included in the sample due to their “roles as capital exporters to the other sample countries, and their capacity to influence the content of the OECD model tax treaty through full membership of the OECD’s Base Erosion and Profit Shifting project and, since that project concluded, the OECD’s Committee on Fiscal Affairs,” see Hearson, Martin (2016). Measuring Tax Treaty Negotiation Outcomes: the ActionAid Tax Treaties Dataset, ICTD Working Paper 47, <http://www.ictd.ac/publication/2-working-papers/99-measuring-tax-treaty-negotiation-outcomes-the-actionaid-tax-treaties-dataset>, pp. 13-14.

A number of case studies and macro-economic analyses have started to quantify the losses incurred by tax treaties, specifically by developing countries.²¹ So, what are tax treaties and what do they do?

The Indonesian Ministry of Finance, in its explanation of its treaty policy and the need for DTAs, returns to the original definition of tax treaties, namely, that they are necessary to avoid double taxation on the same income by two or more tax jurisdictions. Another objective of DTAs, according to the Ministry, is to eliminate tax avoidance and tax evasion by those who earn income in two or more different tax jurisdictions. As well as these two primary objectives, a DTA also aims to promote development by encouraging increases in trade and investment flows between countries that enter into the agreements, notably by reducing withholding tax rates on investors' income between these countries and creating legal certainty on the treatment of such cross-border income. The causal relationship between DTAs and an increase in investment has been highly debated, but is not addressed in this report.

In a tax treaty, the two signatory states allocate taxing rights between their two countries, which are both resident (investing) and source (investment-receiving) states for cross-border investments. Companies in their jurisdictions receive or send income generated by that investment to the other jurisdiction. If a taxpayer has dual residency, there is a tiebreaker rule in the tax treaty which determines which is the resident state for DTA purposes. The DTA prescribes the scenarios under which a state is permitted to have full taxing rights and/or limited taxing rights. In some cases, the resident state has full taxing rights and the source state has a limited taxing right on the same income. Any double taxation is alleviated with a tax credit granted by the resident state. The treaty does not create additional taxing rights for states because tax policy is enshrined in domestic tax law. If a DTA allows a state to tax a certain income (for example, capital gains) but the state does not have a Capital Gains Tax regime, then the state cannot tax that income. Finally, a DTA also harmonises definitions, and supports administrative cooperation between states dealing with cross-border tax matters.

Due to the unequal investment relationship between high and low-income countries, it is developing countries (typically capital importing states) that increasingly lose out through treaty shopping and the loss of taxing rights, as opposed to their capital-exporting counterparts, that are often home to Multinational Corporations (MNCs). This unequal investment relationship occurs because tax treaties restrict the rights of states to tax income at source.²² The combination of treaty shopping along with the failure of resident states to tax income they receive under the treaty up to a regular CIT rate, has resulted in massive revenue losses for all states worldwide.

21 See, for instance, Action Aid (2016). *Mistreated. The tax treaties that are depriving the world's poorest countries of vital revenue*, http://www.actionaid.org/sites/files/actionaid/actionaid_-_mistreated_tax_treaties_report_-_feb_2016.pdf, IMF, May 2014, op cit., CPB Netherlands Bureau for Economic Policy Analysis, van 't Riet, Maarten and Lejour, Arjan, *Ranking the Stars: Network Analysis of Bilateral Tax Treaties*, <https://www.cpb.nl/en/publication/ranking-the-stars-network-analysis-of-bilateral-tax-treaties>; SOMO, 2013, op cit.

22 Brooks, Kim; Krever, Rick (2015). *The troubling role of tax treaties in Michielse, Geerten; Thuronyi, Victor (eds), Tax Design Issues Worldwide*, Kluwer Law International, pp. 160-161.

Increasingly, developing countries are scrutinising tax treaties with countries like the Netherlands and taking back their right to tax, by cancelling them or demanding that the treaties are renegotiated to include higher source taxation rates.²³ Indonesia in 2004 cancelled its DTA with Mauritius, citing treaty abuse and income losses as the reason.²⁴ More recent examples include:

- ▣ Indonesia renegotiating its tax treaty with the Netherlands in 2000²⁵ and 2015²⁶ (the latter effective as of 1 October 2017).
- ▣ Zambia renegotiating its tax treaties with the Netherlands²⁷ and Ireland in 2015²⁸ and with Switzerland in 2017.²⁹
- ▣ Pakistan renegotiating its tax treaties with Ireland³⁰ in 2015 and with Switzerland in 2017.³¹
- ▣ Malawi cancelling its tax treaty with the Netherlands in 2013 then renegotiating a new treaty in 2015 which included improved anti-abuse measures.³²
- ▣ Argentina cancelling treaties with Austria, Chile, Spain and Switzerland in 2013 because the treaties demanded low source-based taxation.³³

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- 23 Action Aid (2016). Mistreated. The tax treaties that are depriving the world's poorest countries of vital revenue, http://www.actionaid.org/sites/files/actionaid/actionaid_-_mistreated_tax_treaties_report_-_feb_2016.pdf
- 24 Lorys Charalambous, LawAndTax-News.com (16 August 2005). 'Mauritius Hopes to Re-start DTAA with Indonesia', https://www.tax-news.com/news/Mauritius_Hopes_To_ReStart_DTAA_With_Indonesia____20810.html. Whilst Mauritius, a smaller economy than Indonesia might have agreed to preferential rates on the expectation that there would be more investments flowing from Indonesia into Mauritius rather than vice-versa, thereby offsetting lost tax revenue, Mauritius started developing a network of equally attractive treaties and attracting international capital by providing tax exemptions and financial secrecy, leading to an influx of corporate restructuring driven by tax minimisation using Mauritius entities. This resulted in investments being routed through Mauritius and profits being repatriated through it with minimal source taxation. It also allowed for offshore Indonesian income to be repatriated into Indonesia under the guise of FDI.
- 25 Letter from the Minister of Foreign Affairs (2002). Verdrag tussen de regering van het Koninkrijk der Nederlanden en de regering van de Republiek Indonesië tot het vermijden van dubbele belasting en het voorkomen van het ontgaan van belasting met betrekking tot belastingen naar het inkomen, met Protocol; Jakarta, 29 januari 2002. URL: <https://zoek.officielebekendmakingen.nl/kst-28417-1.html>
- 26 Letter from the Minister of Foreign Affairs (2015). Protocol tot wijziging van het Verdrag tussen de regering van het Koninkrijk der Nederlanden en de regering van de Republiek Indonesië tot het vermijden van dubbele belasting en het voorkomen van het ontgaan van belasting met betrekking tot belastingen naar het inkomen, en het Protocol daarbij; Jakarta, 29 januari 2002; Jakarta, 30 juli 2015. URL: <https://zoek.officielebekendmakingen.nl/kst-34431-1.html>
- 27 Ernst & Young (2018). Zambia-Netherlands updated tax treaty enters into force. URL: <https://www.ey.com/gl/en/services/tax/international-tax/alert--zambia-netherlands-updated-tax-treaty-enters-into-force>
- 28 Orbitax (2015). Ireland – Zambia: New Tax Treaty between Ireland and Zambia Signed. URL: <https://www.orbitax.com/news/archive.php/New-Tax-Treaty-between-Ireland-10190>
- 29 Orbitax (2017). Switzerland – Zambia: Tax Treaty between Switzerland and Zambia signed. URL: <https://www.orbitax.com/news/archive.php/Tax-Treaty-between-Switzerland-27809>
- 30 Orbitax (2015). Ireland – Pakistan: New Tax Treaty between Ireland and Pakistan signed. URL: <https://www.orbitax.com/news/archive.php/New-Tax-Treaty-between-Ireland-12015>
- 31 MNETax (2018). Swiss, Pakistan tax treaty enters into force. URL: <https://mnetax.com/swiss-pakistan-tax-treaty-enters-into-force-31318>
- 32 ActionAid (2016). Malawi's tax treaties: From independence to year 2015. URL: https://actionaid.org/sites/default/files/aa_malawi_2016_-_malawis_tax_treaties_from_independence_to_year_2015.pdf
- 33 Hearson, M. (2013). Cancelling tax treaties: a lesson from the 1970s. URL: <https://martinhearson.net/2013/03/14/cancelling-tax-treaties-a-lesson-from-the-1970s/>

- ▣ Mongolia cancelling tax treaties with the Netherlands, Luxembourg, Kuwait and the United Arab Emirates in 2012 on the grounds that the treaties facilitated the tax free expatriation of profits from Mongolia's extractive industries.³⁴

3.2 Taxation, democracy and economic equality

For an emerging middle-income country like Indonesia, where financing for development is a critical issue, having sufficient budget resources is vital to realise human rights and tackle poverty. While the domestic poverty rate remains high at 10 per cent, the growth of Indonesia's economy in recent years has moved the country from a low-income to a lower-middle-income World Bank category.³⁵ As the world's 16th largest economy in the GDP ranking³⁶, Indonesia has become a member of the G20 which means that the country's allocation of Official Development Assistance (ODA) has been reduced³⁷, and public finances increasingly have to be raised domestically in the form of taxes. Tax avoidance is therefore particularly troubling as this undermines much-needed revenue mobilisation in countries like Indonesia. The percentage of government revenue from corporate income tax is significant for many countries, particularly lower income countries where, on average, it accounts for 16 per cent of revenue as opposed to eight per cent for higher income countries.³⁸

Taxes do not only finance social goods and services, they are also an important tool in regulating the economy for the public interest. Progressive taxation can lead to redistribution; by taxing high incomes and wealth at a higher rate, wealth can be redistributed and lift the poor out of poverty and increase opportunities for human development. Taxes can also increase democratic representation. The right to tax a population stems from a democratic mandate given to a government, potentially increasing ownership and political demands by citizens over public expenditure and services. Finally, progressive tax systems can promote economic alternatives to short-term profit thinking

34 SOMO (2013). Should the Netherlands sign tax treaties with developing countries?. URL: <https://eurodad.org/files/integration/2013/06/DTA-report-final1.pdf>

35 Between the 1960s and late 1970s, the Indonesian economy grew in terms of a growth in gross domestic product (GDP) (at an average annual rate of almost seven percent, from US\$ 95 billion in 1998 to US\$ 1.016 billion in 2017). Indonesia suffered economically as a result of the Asian Financial Crisis that erupted in the late 1990s but experienced economic recovery with an average GDP growth of 4.6 percent annually in the 2000s, with a subsequent economic slowdown between 2011 and 2015. See Indonesia-Investments for an overview of these World Bank GDP figures: <https://www.indonesia-investments.com/finance/macroeconomic-indicators/gross-domestic-product-of-indonesia/item253> or <https://data.worldbank.org/?locations=XN-ID> for World Bank data on Indonesia's economy.

36 Gross domestic Product (GDP) is the total market value of all final goods and services produced in a country in a given year. Indonesia produced USD 1.016 billion in 2017 and the Netherlands by comparison USD 826 billion. The US, still the largest economy in the world, produced 19.4 trillion. See World Bank GDP ranking, <https://data.worldbank.org/data-catalog/GDP-ranking-table>, accessed 21.1.2019.

37 Worldbank (2019). IBRD – IDA Database: Net Official Development Assistance Received (current US\$) URL: <https://data.worldbank.org/indicator/DI.OODA.ODAT.CD?locations=ID>

38 Picciotto, Sol (June 2016), citing Crivelli et al. (2015) in Taxing Multinational Enterprises as Unitary Firms, International Centre for Tax and Development, Institute of Development Studies, <http://www.ictd.ac/publication/2-working-papers/126-taxing-multinational-enterprises-as-unitary-firms>, p.7.

by influencing the behaviour of individuals and corporations through increasing the costs of polluting behaviour, and incentivising non-polluting activities.³⁹

3.3 The importance of taxation for women's rights

It was already illustrated above that the government budget of developing countries is heavily dependent on corporate taxation. The impact of corporate tax avoidance is also gendered. The main two channels through which reduced government spending due to tax avoidance impacts the position of women and girls is through redistribution of unpaid care and by ensuring that their rights are fulfilled.

Women, especially in developing countries, conduct the vast majority of unpaid care work. In Indonesia, women perform 93.7% of the unpaid care work.⁴⁰ Due to the great amount of time spent on unpaid care work, women are unable to earn their own income. They are therefore more dependent on government spending on healthcare, education, electricity, water and sanitation to realize basic needs. This dependence is, in Indonesia, for example related to the high maternal mortality rate. Annually in Indonesia, about 20,000 women die from causes related to childbirth. The main reasons for this (poorly trained health staff, limited local transportation, and limited emergency obstetric care) are all related to government spending on the public budget.⁴¹

In addition, women are heavily dependent on public services, such as education, to be able to take on a job and earn their own income. Following various studies, only 50% of the Indonesian women that are able to work, participate in the labour force. Furthermore, about 12% of the Indonesian women are illiterate, versus 6% for men.⁴² Also women, on average, have over one year less schooling than men. In order to increase the participation of woman in the formal labour force of Indonesia sufficient government spending on education is essential, which is generally underfunded, partially because of tax avoidance.

Furthermore, when other types of taxes, such as consumption taxes, are raised to offset the government budget deficit stemming from corporate tax avoidance, the impact on women is generally stronger than on men. The main reason thereof is the spending pattern of women, as they generally have to spend a bigger part of their income, relative to men, on daily necessities of the household including for their children. As people in poverty generally spend a bigger part of their income on consumption, and as people have to pay the same rate of VAT, irrelevant of their income, consumption taxes are regressive. The increase of VAT taxes, to offset budget deficits due to tax avoidance, therefore have a multiplier effect for women in low-income groups.

39 Cobham, Alex. "The Oxford Council on Good Governance Taxation Policy and Development." (2005).

40 Interactions. Unpaid care work in Indonesia. <http://interactions.eldis.org/unpaid-care-work/country-profiles/indonesia>

41 The Asia Foundation, Asian Development Bank, Canadian International Development Agency, National Democratic Institute, The World Bank (2006). Country Gender Assessment. <https://www.adb.org/sites/default/files/institutional-document/32231/cga-indonesia.pdf>

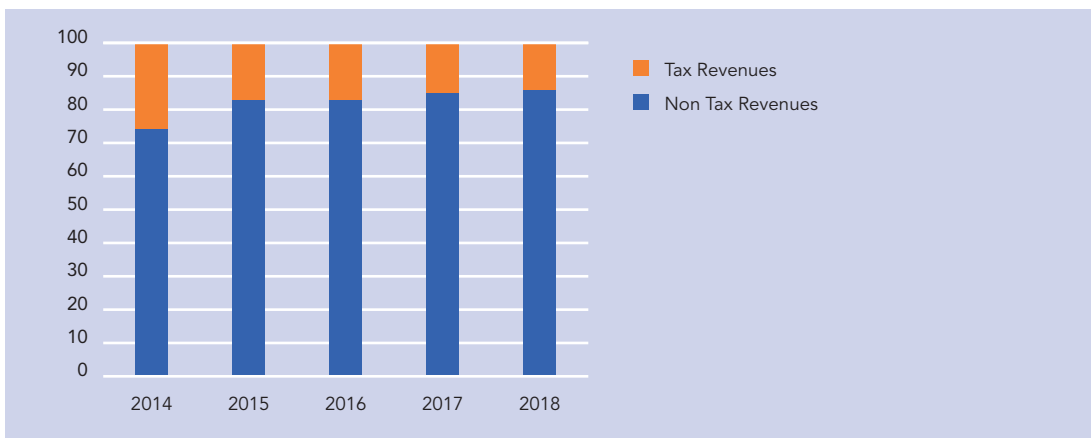
42 The Asia Foundation, Asian Development Bank, Canadian International Development Agency, National Democratic Institute, The World Bank (2006). Country Gender Assessment. <https://www.adb.org/sites/default/files/institutional-document/32231/cga-indonesia.pdf>

In order to offset the detrimental effect of corporate tax avoidance on women gender sensitive budgeting is needed. Gender sensitive budgeting 'seeks to ensure that the collection and allocation of public resources is carried out in ways that are effective and contribute to advancing gender equality and women's empowerment.'⁴³

3.4 The problem of corporate tax compliance in Indonesia

The most important source of income for Indonesia is the taxation of corporate income and, in particular, the taxation of large global corporations. About 86 per cent⁴⁴ of total state revenues derive from tax, making tax compliance an important government priority. From 2014 – 2018, tax revenue gradually increased, both in absolute and relative terms. In 2014 tax revenue comprised 73 per cent of total state revenue. In 2015 tax revenue surpassed 80 per cent, and in 2018 tax revenue made up 86 per cent of total state revenue (see Figure 2).

Figure 2 Indonesian government revenues (2014-2018)



Source: Central Statistics Bureau Indonesia, 2018

43 UN Women (2019). Gender Responsive Budgeting. URL: <https://unwomen.org.au/our-work/focus-areas/what-is-gender-responsive-budgeting/>

44 BPS data in 2018, <https://www.bps.go.id/subject/13/Keuangan.html#subjekViewTab4|accordion-daftar-subjek2>

However, this increase in tax revenue is not reflected in the tax compliance rate – the country's tax to GDP ratio – as Indonesia has one of the lowest tax ratios in the ASEAN and G20 region. Although US\$ 360bn worth in assets were declared during a recent tax amnesty in Indonesia⁴⁵, intended to increase tax compliance, the tax ratio still fell from 10.8 per cent in 2014 to 9.9 per cent in 2017.⁴⁶

As mentioned above, there is a growing body of literature quantifying losses incurred by tax avoidance and treaty shopping.⁴⁷ The US is estimated to lose between USD 77 billion and USD 111 billion annually, for instance. The International Monetary Fund (IMF) calculates long-term losses for advanced economies are around 0.6 per cent of their GDP, but proportionately three times greater in developing countries, reaching almost 2 per cent of GDP.⁴⁸ Zucman et al estimate that close to 40% of multinational profits (US\$600 billion) are shifted to tax havens globally.⁴⁹ Due to limitations in available data, however, these reports are predominantly based on estimations. Some focus on losses generated by treaty shopping and compare domestic WHT rates with lower (and unduly applied) treaty WHT rates on outgoing passive income. Due to their residence bias, tax treaties also generate tax losses on active income because taxing rights are not equally divided between source countries and residence countries. This imbalance particularly affects income taxes on capital gains, which can easily be allocated to a letterbox company under tax treaties, thereby depriving the source state of income.

The Dutch Bureau for Economic Policy Analysis (*Centraal Plan Bureau*, CPB) estimated losses, or rather a percentage reduction of effective tax rates related to substantive provision in treaties, as well as treaty shopping.⁵⁰ The top four countries identified as network hubs for treaty shopping are the United Kingdom, Estonia, Singapore and the Netherlands. Indonesia's two top foreign investing countries are Singapore and the Netherlands, with which it has bilateral tax treaties. It is reasonable to conclude that the losses incurred by these treaties are substantial.

Based on firm-level intra-group financing data, Weyzig calculated that from interest payments alone, Dutch Special Purpose Entities (SPEs) in 2010 channelled €0.6 billion from Indonesian companies to debt security holders because of the zero per cent WHT rate on interest stipulated in the Indonesia-Netherlands DTA until 2017, thereby avoiding between 10 to 20 percent WHT.⁵¹ Companies

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- 45 Reuters (2017). Late rush to join Indonesia tax amnesty after \$360 billion of assets declared. URL: <https://www.reuters.com/article/us-indonesia-economy-tax/late-rush-to-join-indonesia-tax-amnesty-after-360-billion-declared-idUSKBN1720VJ>
- 46 Worldbank (2019). IBRD – IDA Database: Tax revenue (% of GDP). URL: <https://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS?locations=ID>
- 47 Clausing, Kimberly A. (2015). Beyond Territorial and Worldwide Systems of Taxation. *Journal of International Finance and Economics*, 15, 2: 43-58.
- 48 Crivelli, E., De Mooij, R. & Michael Keen (2015). Base Erosion, Profit Shifting and Developing Countries. IMF Working Paper No. 15, 118.
- 49 Zucman, G., Tørsløv, T.R. & Ludvig S. Wier (2018). The Missing Profits of Nations. NBER Working Paper No. 24701.
- 50 CPB Netherlands Bureau for Economic Policy Analysis (2014). 'Ranking the Stars. Network Analysis of Bilateral Tax Treaties', Maarten van 't Riet & Arjan Lejour, CPB Discussion Paper 290, https://www.cpb.nl/sites/default/files/publicaties/download/cpb-discussion-paper-290-ranking-stars_0.pdf
- 51 Weyzig, Francis (2013). Taxation and Development. Effects of Dutch tax policy on taxation of multinationals in developing countries Summary of PhD dissertation of Francis Weyzig (Radboud University, development studies), http://francisweyzig.files.wordpress.com/2013/06/weyzig_taxation_and_development_phd_summary.pdf

identified by Weyzig that used this type of Dutch intermediary financing company are Persero, Asia Pulp & Paper, Berlian Laju Tanker, Listrindo, Indosat, Indika Energy, Gajah Tunggal, Global Mediacom, Bakrie Sumatera Plantations, and Arpeni Pratama Ocean Line.

Based on aggregated bilateral investment and income data, SOMO calculated in 2013 that Indonesia suffered an annual tax loss of approximately €56 million because of treaty shopping using Dutch conduits.⁵² These figures could not be updated as the Central Statistics Bureau of the Netherlands (CBS) stopped publishing crucial data on how much capital income the Netherlands receives from its FDI stock abroad and from WHT on incoming interest and dividend payments.

The Corruption Eradication Commission of Indonesia found many mining companies in Indonesia engage in tax avoidance and evasion. Their data, and that of the Energy and Minerals Ministry, and other related agencies, show that 24 per cent of 7,834 companies registered at the DGT do not have a taxation ID number and 35 per cent do not report their taxes.⁵³

The same problem exists in the palm oil plantation industry in Indonesia. Tax avoidance research conducted by Indonesia Corruption Watch in 2014, which involved nine big companies, showed a potential loss of Rp5.6 trillion⁵⁴ in tax revenues.⁵⁵

Research by Suroyo & Danubrata found that Indonesia loses about US\$ 15.6bn of tax revenue annually.⁵⁶ Kristiaji discovered that approximately 4,000 multinational enterprises (MNEs) in Indonesia report continual losses for many years in their financial statements, thereby effectively avoiding corporate income taxation.⁵⁷

3.5 Evidence of tax avoidance schemes used in Indonesia

In the past decade, Indonesia has actively attracted FDI through tax incentives in the hope of increased tax returns from income generated in the country.⁵⁸ However, 70 per cent of foreign-owned companies who filed income tax returns showed 'tax losses' for five or more years and consequently did not pay corporate income tax during that period. A study by the Indonesian

52 SOMO (2013). Should the Netherlands sign tax treaties with developing countries?, via: <https://www.somo.nl/should-the-netherlands-sign-tax-treaties-with-developing-countries/>

53 Saputra, Wiko (2015). Illicit Financial Flow and Tax Crime in Mining Sector. PWYP Brief Note, No. 1/October 2015.

54 About €356 million. Based on the average Indonesian Rupiah/ EURO exchange rate for 2014 (1 EURO = 15736 Rp).

55 ICW (2014). Industry Structure and the Largest Palm Oil Company in Indonesia. Research Report.

56 Suroyo, G., & Danubrata, E. (2015). Indonesia to crack down on corporate tax avoidance. Reuters. Retrieved 3 March, 2016, from <http://www.reuters.com/article/us-indonesia-tax-taxavoidance-idUSKBN0LS05320150224>

57 Kristiaji, B. (2015). Multinational firm's losses and profit shifting behaviour in Indonesia: Some comments. DDTC Working Paper. Retrieved 13 November, 2015, from <http://dannidarussalam.com/working-papers>

58 Rahayu, Ning (2010) Evaluasi Regulasi Atas Praktik Penghindaran Pajak Penanaman Modal Asing [Evaluation of the regulation to prevent tax avoidance by foreign investors], Journal of Accounting and Finance Indonesia, June 2010, Vol. 7, No. pp. 61-78.

Directorate General of Taxes⁵⁹ found that the non-payment of taxes is largely explained by the practice of tax avoidance, especially transfer pricing through intercompany transactions.⁶⁰

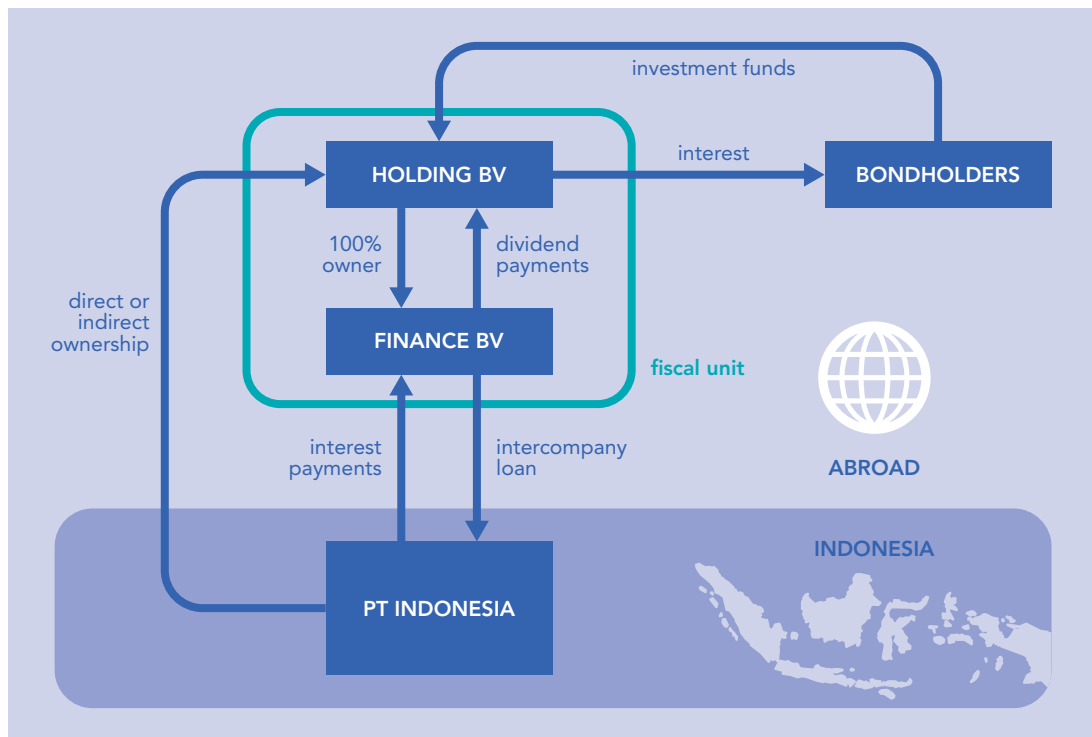
A number of studies have been made, notably in the Political and Social Sciences Faculty of the University of Indonesia, which detail tax avoidance practices of foreign-owned companies in Indonesia and analyse the policy loopholes which enable these practices, as well as anti-avoidance measures taken by the Indonesian government.⁶¹ Research from 2008, based on case studies and interviews with tax practitioners, found that the most common (international) tax avoidance schemes in Indonesia involve transfer pricing, thin capitalisation, treaty shopping and using tax havens to divert income.⁶² These transfer pricing practices include the inflation of costs through a) high management services, technical services and other services to the parent company, b) royalty fees charged on the use of trademarks, and c) increasing the cost of raw materials and/or minimising income from the sale of goods (various different arrangements exist to lower sales revenue and inflate costs of the Indonesian subsidiary).

The thin capitalisation schemes identified in this research involved Indonesian subsidiaries being disproportionately financed by intra-group loans rather than equity (share capital), in order to increase costs at the subsidiary level through paying interest payments to parent companies or related entities. These include direct parent loans, parallel loan schemes using related entities abroad and back-to-back loans, which mask a related entity transaction by issuing the loans and interest payments via banks; the latter two make it harder for the revenue authorities to identify abuse.

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- 59 Rahayu, Ning (2008) *Praktik Penghindaran Pajak (Tax Avoidance) Pada Foreign Direct Investment Yang Berbentuk Subsidiary Company (Pt. Pma) Di Indonesia (Suatu Kajian Tentang Kebijakan AntiTax Avoidance)* [Tax avoidance practices of foreign direct investors through subsidiary companies (PT PMA) in Indonesia. A review of Indonesia's anti-tax avoidance policy], Doctoral dissertation, University of Indonesia, Faculty of Social Science and Political Science, FISIP UI.
- 60 Transfer pricing is a method to determine the 'commercial' price of transactions that occur between two companies of the same entity. Through Transfer Pricing, companies have to align their intercompany transaction with an equivalent transaction between two unrelated parties. Transfer pricing has the goal to prevent companies to use their intercompany transaction, inter alia, to avoid taxation.
- 61 Safril (2005), for instance, examined the practice thin capitalisation at PT Unitex Tbk for the period 1984-2002: Safril. 2005. *Thin Capitalization Sebagai Bentuk Penghindaran Pajak Pada PT. Unitex Tbk. Periode 1984-2002*. Tesis, Program Kekhususan Ilmu Administrasi dan Kebijakan Perpajakan, Program Pascasarjana FISIP UI, 2005; Octo Pangaribuan, Calvin (2007) analysed the implementation of Controlled Foreign Corporation Rules in Indonesia: *Analisis Implementasi Controlled Foreign Corporation Rules di Indonesia Dalam Upaya Mencegah Penghindaran Pajak (Suatu Studi Komparasi Dengan Australia dan Bentuk Umum)*. Tesis, Program Kekhususan Ilmu Administrasi dan Kebijakan Perpajakan, Program Pascasarjana FISIP Universitas Indonesia.; Septriadi (2003) examined the transfer pricing schemes on tangible goods: Septriadi, Danny Djayaprawira. 2003. *Ketetapan Pajak Kurang Bayar Karena Abuse of Transfer Pricing Tangible Goods (Studi Kasus PT X)*. Tesis, Program Kekhususan Ilmu Administrasi dan Kebijakan Perpajakan Program Pascasarjana FISIP UI, 2003.; and Setyowati (2010) analysed anti-treaty shopping practices and provisions on a number of tax treaties (DTA) in Indonesia; Setyowati, Eny. 2010. *Analisis ketentuan anti treaty shopping dalam upaya pencegahan penyalahgunaan persetujuan penghindaran pajak berganda (DTA) di Indonesia*. Tesis, Program Kekhususan Ilmu Administrasi dan Kebijakan Perpajakan Program Pascasarjana FISIP UI, 2010.
- 62 Rahayu, Ning (2008) *Praktik Penghindaran Pajak (Tax Avoidance) Pada Foreign Direct Investment Yang Berbentuk Subsidiary Company (Pt. Pma) Di Indonesia (Suatu Kajian Tentang Kebijakan AntiTax Avoidance)* [Tax avoidance practices of foreign direct investors through subsidiary companies (PT PMA) in Indonesia. A review of Indonesia's anti-tax avoidance policy], Doctoral dissertation, University of Indonesia, Faculty of Social Science and Political Science, FISIP UI.

The treaty shopping case studies typically showed intra-group financing arrangements using the zero WHT on outgoing interest payments under the Indonesia-Netherlands DTA⁶³ to shift income out of Indonesia to tax havens or to attract foreign investment through the Netherlands (see Figure 3). The forthcoming case study briefing to be published by Prakarsa and SOMO confirms the avoidance of Indonesian WHT by Indonesian firms.

Figure 3 Treaty shopping through Dutch loan financing scheme



Source: authors

The figure above shows a graphical representation of a tax avoidance structure, involving the Netherlands and Indonesia. It demonstrates the use of letterbox companies in the Netherlands for the attraction of investment by the Indonesian parent company. The affiliate (in this case Holding BV) attracts capital from bondholders and shifts this investment, through Finance BV towards Indonesia. As the Netherlands does not levy withholding taxes on interest payments, no withholding taxes on the interest payments need to be paid by the bondholders. Furthermore, as the DTA

63 Article 11(4) of the treaty stipulates that interest from commercial debt of more than two years and credit sales from commercial, industrial, and science utilities are tax free, which is typically abused to shift profits out of Indonesia (Since late 2017 subjected to 5% WHT under the 2015 Protocol).

between Indonesia and the Netherlands does not levy withholding taxes on interest⁶⁴, no or very limited withholding tax has to be paid over the transaction between Finance BV and PT Indonesia. Whenever PT Indonesia would directly attract investment it would either have to pay, the generally higher, withholding tax of the applicable DTA or the domestic Indonesian withholding tax on interest (15%). Most commonly, the Dutch letterbox companies are split between a finance and holding company. As the Finance BV Company does not directly attract investment from bondholders it is difficult to signal tax avoidance by the Indonesian tax authority. The powers of the recipient over the dividend payments do not seem to be constrained in the sense that the recipient is obliged to pass the payment received to another person. This is one necessary requirement to fulfil for the OECD definition of beneficial ownership.⁶⁵

A study by Setyowati confirmed the widespread use of Dutch SPEs in treaty shopping and examined anti-treaty shopping provisions in a number of tax treaties in Indonesia.⁶⁶ Company-level data and financial data confirm the use of Dutch treaties for treaty shopping. The study also identified tax avoidance schemes using Controlled Foreign Corporations in tax havens.

3.6 The role of tax treaties in tax avoidance in Indonesia

In Indonesia, double taxation prevention is regulated in Article 32A of Law No. 7 (1983). This was recently revised by Law No. 26 (2008) on Income Tax (hereafter Income Tax Law) which stated that “the government is authorised to conduct agreements with the other country’s government to prevent double taxation and tax evasion.”⁶⁷

Article 26 of the Income Tax Law stipulates that any business entity in Indonesia that makes payments to a foreign resident taxpayer (such as technical service fees, interest, dividends or royalties) is required to withhold 20 per cent of tax on such transactions.

Under a DTA, the rates are subject to change (mostly lowered), depending on the DTA between Indonesia and the other country. Indonesia has signed Double Taxation Prevention Agreements with 68 countries (see Annex), including the Netherlands. To date, there have been four amendments of the Indonesia-Netherlands DTA (in 1973, 1993, 2003 and 2015).

64 Until 2015 no withholding taxes were applied through the DTA on interest payments on loans with a term of more than 2 years. From 2015 onwards a withholding tax of 5% was applicable on long-term loans.

65 OECD (2012). OECD Model Tax Convention: Revised proposals concerning the meaning of ‘Beneficial Owner’ in articles 10, 11 and 12. URL: <https://www.oecd.org/ctp/treaties/Beneficialownership.pdf>

66 Setyowati, Eny. 2010. Analisis ketentuan anti treaty shopping dalam upaya pencegahan penyalahgunaan persetujuan penghindaran pajak berganda (DTA) di Indonesia. Tesis, Program Kekhususan Ilmu Administrasi dan Kebijakan Perpajakan Program Pascasarjana FISIP UI, 2010.

67 Ministry of Finance of the Republic of Indonesia (2017). THE APPLICATION PROCEDURE OF DOUBLE TAXATION CONVENTION DIRECTOR GENERAL OF TAXES, DIRECTOR GENERAL OF TAXES REGULATION, NUMBER PER-10/PJ/2017, https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=2ahUKEwj3ocOO_e3hAhUBy6QKHdetAugQFjAAegQIBRAC&url=https%3A%2F%2Fwww.netherlandsandyou.nl%2Fbinaries%2Fnetherlandsandyou%2Fdocuments%2Fpublications%2F2017%2F09%2F18%2Funofficial-translation-tax-indonesia%2FTax%2BInfo%2B%25282%2529.pdf&usq=AOvVaw1uEKsT9LR1in2OYRugi2KU

Indonesia developed its tax treaty network from the 1970s onwards, when the authoritarian regime under President Suharto opened the country to foreign investment under the 1967 Foreign Investment Law. Indonesia entered into a number of treaties with developed, capital-exporting countries: the Netherlands (1973), Canada (1979), France (1979) and Japan (1982).⁶⁸ Karyadi and Darussalam⁶⁹ argue that Indonesia protected its source taxation rights in the early treaties, but later treaties with developing countries – when Indonesia itself became a capital-exporting state – “are more compatible with the OECD Model Convention, protecting Indonesia’s rights as a residence country.” The analysis of the Indonesia-Netherlands DTA does not support the argument that the previous DTAs protected taxation at source or led to increased productive FDI because tax losses through treaty shopping are not systematically and historically quantified by academic studies, although they cost Indonesia millions of dollars every year. Moreover, Indonesian companies themselves avoid domestic taxes using the Indonesia-Netherlands DTA, thus distorting incoming FDI data. Investments via Dutch mailbox companies, for example, are treated as Dutch investment on paper, yet may well originate from Indonesia. Of the 68 tax treaties that Indonesia has in force (see Annex), it has terminated only one (Mauritius 2005).

Research conducted by the Indonesian Ministry of Finance (2012)⁷⁰ reviewed DTAs between Indonesia and five other developed countries (Korea, Japan, China, the US and the UK) and concluded that while DTAs have a negative impact in the short term, on FDI (a decrease of US\$ 222.5m), they have a positive impact in the medium term (an increase of US\$ 309.1m) and long-term (an increase of US\$ 221m). It should be noted, however, that whilst the relationship between DTAs and FDI is often assumed by policy-makers, it is not similarly assumed in academic literature because firstly, there are methodological problems in identifying a causal relationship (the signing of a treaty, for example, might be triggered by the improvement of the economic relations between two states, so the political decision to sign the treaty comes after the economic development rather than the other way around) and secondly, even if a statistically relevant and consistent relationship could be identified, there is always a possibility that both are being influenced by a third causal factor.⁷¹

68 Karyadi, Freddy & Darussalam (2017) *Tax Treaty Disputes in Indonesia*, in E. Baistrocchi (Ed.), *A Global Analysis of Tax Treaty Disputes* (Cambridge Tax Law Series, pp. 1234-1282). Cambridge: Cambridge University Press, p. 1235.

69 Karyadi, Freddy & Darussalam (2017) *Tax Treaty Disputes in Indonesia*, in E. Baistrocchi (Ed.), *A Global Analysis of Tax Treaty Disputes* (Cambridge Tax Law Series, pp. 1234-1282). Cambridge: Cambridge University Press.

70 Nurhidayat, R. (June 2012). *Tax Treaty and Foreign Direct Investment in Indonesian*, *Finance and Banking Journal*, Vol.14 No.1 http://www.academia.edu/11577627/R._Nurhidayat

71 For some in-depth debates, see Sauvants, Kar; P.; Sachs, Lisa E. (2009). *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties and Investment Flows*. Oxford University Press; Barthel, F., Busse, M., & Neumayer, E. (2010). *The Impact of Double Taxation Treaties on Foreign Direct Investment: Evidence from Large Dyadic Panel Data*. *Contemporary Economic Policy*, 28(3), 366-377. SOMO (2013) provides a literature overview of econometric studies on the assumed causal link between DTAs and FDI in: *Should the Netherlands sign tax treaties with developing countries?*, June 2013.

4 The Netherlands: a conduit country

This chapter highlights the Netherlands' high investment statistics and explains the disproportionate nature of Dutch in- and outward investments measured in FDI data in relation to the country's material economic output as measured by GDP. While the Netherlands is, on paper, the biggest investor in many countries, including Indonesia, this investment is, sometimes over 90 per cent, structured via letterbox companies owned by non-Dutch global corporations.⁷² This chapter goes on to explain the policies that enable Dutch conduit structures, related to domestic tax and corporate law and the Dutch tax treaty policy and network.

4.1 The Netherlands as offshore financial centre: FDI in relation to GDP

The Netherlands, which has nearly 100 bilateral tax treaties in force⁷³, is used as a conduit country by multinational corporations in order to structure financial flows from source countries to tax havens. This is reflected in the fact that the Netherlands ranked number one in worldwide investment tables in 2017, with disproportionately large inward and outward flows of capital compared to the size of its economy, illustrated in Figure 4 below in terms of GDP. In 2017, the Netherlands ranked number 18 in global GDP tables.⁷⁴ With more than US\$ 5,000bn inward investments, and more than US\$ 6,000bn outward investments in 2017, the country overtakes all other economies in FDI statistics.⁷⁵

As Figure 4 below indicates, the Netherlands is not the only country with a disparate FDI/GDP ratio. Luxembourg has a staggering ratio of 64.3 and 77.6 for inward and outward direct investment, respectively. For regular economies (those that are not offshore financial centres or tax havens), the FDI/GDP ratio ranges between 0.2 and 0.5. For tax havens, this figure typically ranges between 1 and 7.5. Some of these tax havens are relatively small economies (Ireland, Switzerland and the Netherlands). The Netherlands has a ratio of 6.1, putting it well within the range of a typical tax haven.

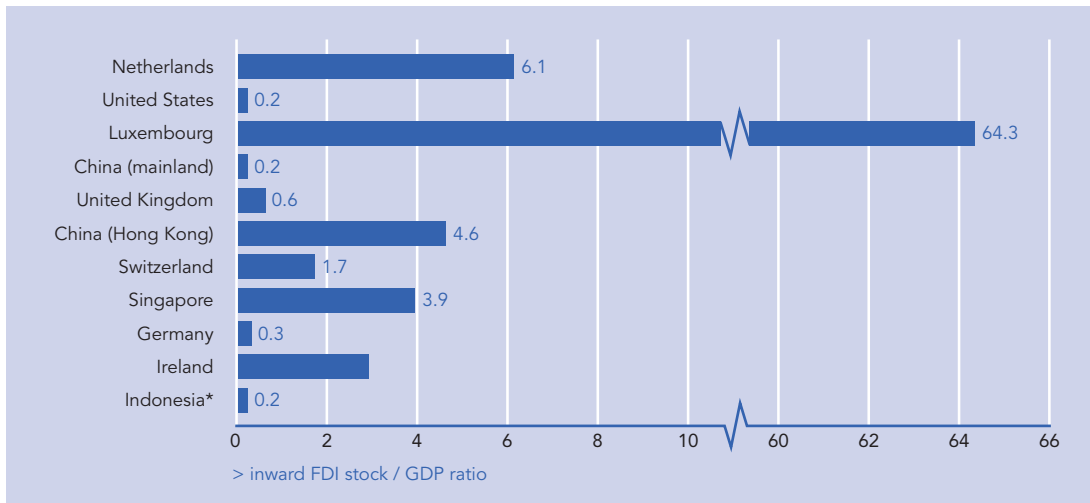
72 SOMO (2015). Tax Free Profits: <https://www.somo.nl/tax-free-profits-2/>

73 For a current overview, see website of the Dutch revenue authority: https://www.belastingdienst.nl/wps/wcm/connect/bldcontenten/belastingdienst/individuals/tax_arrangements/tax_treaties/overview_of_treaty_countries/ + <https://www.rijks-overheid.nl/onderwerpen/belastingverdragen/overzicht-van-belastingverdragen?pagina=7>

74 <http://unctadstat.unctad.org/wds/TableView/tableView.aspx?ReportId=96>, downloaded 22 January 2019.

75 IMF, Coordinated Direct Investment Survey (CDIS). Accessed 25 January 2018, <http://data.imf.org/?sk=40313609-F037-48C1-84B1-E1F1CE54D6D5&slid=1482331048410>

Figure 4 Inward direct investment, top 10 reporting economies, 2017 (IMF)



Source: IMF Coordinated Direct Investment Survey (CDIS)⁷⁶; UNCTAD STAT⁷⁷.

*Indonesia has been added for comparison.

Figure 4 shows how small economies have attracted FDI by developing preferential tax and investment regimes. The Dutch tax regime has evolved into a system used by foreign companies to set up subsidiaries in the Netherlands by offering low WHT rates on dividends, royalties and interest (used for avoiding income tax, base erosion or profit shifting) and a residence bias (useful for avoiding capital gains tax) in almost 100 countries of operation.⁷⁸ In addition, the Dutch large bilateral investment treaty (BIT) network protects investors from any legal changes in source countries that might affect their profit, even when the legislation is passed in the public interest of that country.

Rather than engaging in real economic activities in the Netherlands, the subsidiaries used for tax planning and investment protection are typically mailbox companies that provide a formal domicile and act as a conduit structure to re-route capital flows. As such, SPEs allow corporations and financial institutions to legally structure their operations on paper in a way that conceals the actual geography of economic activities. This, in turn, lowers their taxes and may assist in avoiding regulation.

76 IMF CDIS. URL: <http://data.imf.org/?sk=40313609-F037-48C1-84B1-E1F1CE54D6D5>, accessed 25 January 2018.

77 UNCTAD STAT, FDI statistics. URL: <https://unctad.org/en/Pages/DIAE/FDI%20Statistics/FDI-Statistics.aspx>, accessed 25 January 2018.

78 CPB Netherlands Bureau for Economic Policy Analysis (2019). 'Conduit country the Netherlands in the Spotlight', Arjan Lejour, Jan Möhlmann & Maarten van 't Riet, CPB Policy Brief January 2019, URL: https://www.cpb.nl/sites/default/files/publicaties/download/cpb-discussion-paper-290-ranking-stars_0.pdf; Vleggeert, J. and Vording, H., How The Netherlands Became A Tax Haven for Multinationals (January 2019).

It is no surprise, therefore, that the two biggest origin countries of investment into the Netherlands are the United States (from American multinational companies who own Dutch letterbox companies) and Luxembourg (from parent entities of foreign multinational companies of various origins that own Dutch letterbox companies). Dutch entities themselves own (invest in) subsidiaries in Switzerland, the UK and the US (see Table 1).

Table 1 Direct investment from and to the Netherlands. Top five source and destination countries

Inward Direct Investment		Outward Direct Investment	
Total investment	5,005	Total investment	6,174
United States	955	United States	918
Luxembourg	698	United Kingdom	652
United Kingdom	480	Switzerland	492
Switzerland	292	Luxembourg	487
Bermuda	289	Germany	358

Source: IMF CDIS, 2017 (US Dollars, billion)

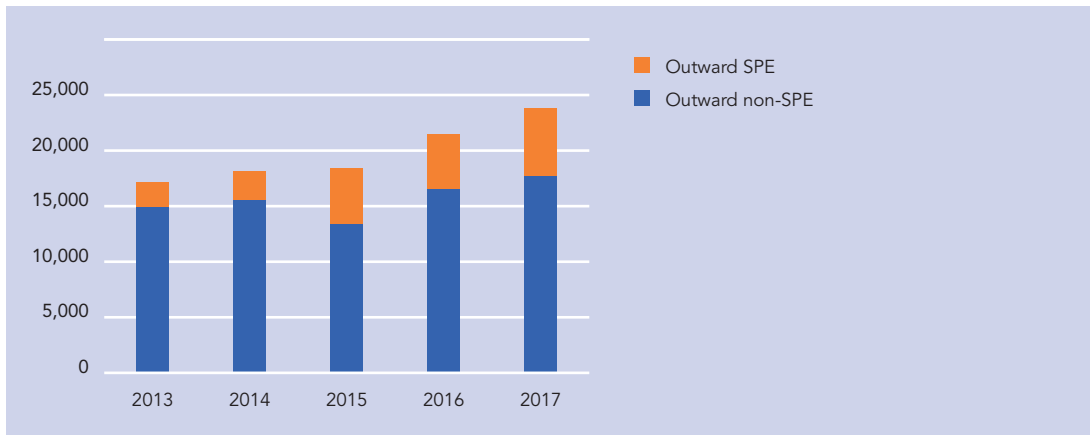
The Dutch Central Bank confirms this picture and reported that there were approximately 15,000 SPEs in the Netherlands in 2017. According to 2017 Dutch Central Bank data, the direct inward investments of all SPEs in 2017 was nearly € 3,685bn (around US\$ 4,422bn), whereas outward investments amounted to almost €4,060bn (around US\$ 4,872bn).⁷⁹ This means that the vast majority of in- and outward investments (respectively around 80 and 90 per cent) of the Netherlands are related to SPEs⁸⁰ and explains why the Netherlands is often called a tax haven, a conduit country or an offshore centre.

The statistics showing Dutch investment in Indonesia confirms that the Netherlands is used as a conduit country. Over the past years, more than 75 per cent of FDI in Indonesia was structured through SPEs.

79 Dutch Central Bank, 'Geografie directe investeringen BFI's', data for 2017, accessed 14 January 2019, available at <https://statistiek.dnb.nl/downloads/index.aspx#/details/geografie-directe-investeringen-bfi-s/dataset/f8af558c-65eb-46e9-b019-62a3daa264a2/resource/e193c8dc-98f1-47d6-b00f-600de659b5a0>

80 Comparison with OECD and DNB data.

Figure 5 Dutch investments in Indonesia through mailbox companies in million US\$



Sources: IMF, Coordinated Direct Investment Survey (CDIS), OECD investment data.

A recent study by the Dutch Central Bureau for Economic Policy Analysis (CPB)⁸¹ shows that the Netherlands is an important conduit in the international tax planning of multinationals and that an amount equal to € 200bn, in terms of dividends, royalties and interest, is annually channelled through the Netherlands, mainly through letterbox companies. The ultimate source and destination of these financial flows is unclear, as many countries can be part of one and the same chain. The next stop in most royalties-related flows is Bermuda, while they mostly stem from the United States. Most interest and dividend related flows come from and go to other conduit countries such as Ireland, Luxembourg and Switzerland. In this research, the CPB states that the planned conditional (intra-group) WHT on interest and royalties by the Dutch government will not sufficiently address the conduit position of the Netherlands and that more ambitious action is needed.

In February 2019 the European Court of Justice published a ruling which could have severe consequences for the role of the Netherlands as a conduit country. The ruling of the judge reflected on the question whether a dividend and interest payment, made from an EU company based in a EU country (country a) to another company within the EU (country b) and subsequently passed to the ultimate parent company outside the EU, could apply for the withholding tax exemption, as applicable in country b. According to the Judgement: *“A group of companies may be regarded as being an artificial arrangement where it is not set up for reasons that reflect economic reality, its structure is purely one of form and its principal objective or one of its principal objectives is to obtain a tax advantage running counter to the aim or purpose of the applicable tax law. That is so inter alia where, on account of a conduit entity interposed in the structure of the group between the company that pays dividends and the company in the group which is their beneficial owner,*

81 CPB (2019). Doorsluisland NL doorgelicht, <https://www.cpb.nl/sites/default/files/omnidownload/CPB-Policy-Brief-2019-01-Doorsluisland-NL-doorgelicht.pdf>

payment of tax on the dividends is avoided.”⁸² What the actual effect of this ruling will be on the role of the Netherlands as a conduit country remains to be seen.

4.2 What makes the Dutch tax regime so attractive?

4.2.1 Substance requirements

Dutch law stipulates a number of substance requirements for multinationals that want to enjoy the Dutch tax regime and its bilateral tax treaties. Because these substance requirements are relatively weak, the role they play in the use of the Netherlands as a conduit country has attracted attention over the last couple of years. Substance requirements are in the following situations of relevance for companies that want to make use of the Dutch network of tax treaties:

- ❑ Foreign intermediate holding companies: The substance requirements for foreign intermediate holding companies are outlined in Box 1.⁸³ Whenever the companies fail to adhere to these substance requirements the government can spontaneously exchange ruling information with the (tax treaty) source country. The company is furthermore not allowed to request a ruling.
- ❑ In order to request a ruling (both Advanced Pricing Agreements and Advanced Tax Rulings) a company has to adhere to substance requirements, as outlined in Box 1. However, in November 2018 the Dutch Secretary of Finance informed Parliament that there will be a reform of the international tax ruling regime to incorporate a substance requirement based upon ‘economic nexus’, defined as: *‘economical operational activities that are actually carried out for the risk and reward of the company in the Netherlands’*. The specific outcome of the reform of the tax ruling regime is expected to be finalized in 2019.
- ❑ Dividend withholding exemption: One of the attractions of the Dutch fiscal regime is its dividend withholding exemption. The Dutch government, however, introduced an anti-abuse rule which states that the dividend withholding exemption at source does not apply if, briefly summarised, the foreign shareholder holds the interest in the Dutch entity with the main purpose (or one of the main purposes) of avoiding Dutch dividend WHT (“subjective test”). If Dutch tax is indeed avoided by the imposing of a foreign holding company, then the structure or transaction should be assessed as to whether it is artificial and/or not set up for valid business reasons (“objective test”). A structure or transaction is not (deemed) artificial if it has been set up for valid business reasons that reflect economic reality. Valid business reasons are deemed to be met (for instance) if the parent company of the Dutch entity meets specific substance requirements, as stipulated in Box 1.

82 Court of Justice (2019). Judgement of the Court (Grand Chamber), In Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16. URL: <http://curia.europa.eu/juris/document/document.jsf?text=&docid=211047&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=4342884>

83 Substance requirements number 1 till 8 of box 1 were introduced in 2014 for both financial services companies and foreign intermediate holding companies and extended with requirements 9 & 10 from April 2018 onwards.

Box 1 Dutch substance requirements for foreign intermediate holding companies and financial service providers⁸⁴

- 1 At least 50 per cent of the members of the board of directors, with a right to make decisions, live or factually reside in the Netherlands;
- 2 The directors residing in the Netherlands have sufficient knowledge to perform their activities in their capacity as a director of the Dutch company. The company has the adequate personnel – either of its own or from third parties – for the adequate execution and registration of the transactions;
- 3 The (most important) board decisions are made in the Netherlands;
- 4 The (main) bank account of the Dutch company is in the Netherlands;
- 5 The bookkeeping of the Dutch company takes place in the Netherlands;
- 6 The Dutch company has complied with all its tax obligations, at least up to and including the moment of filing the APA/ATR;
- 7 The Dutch company has its registered address in the Netherlands, while the company is, according to its best knowledge, not (also) a resident of another jurisdiction for tax purposes;
- 8 The Dutch company's minimum equity is adequate in relation to the functions performed (taking into account the risks assumed and assets used);
- 9 The Dutch company incurs annual salary costs of at least € 100,000 in relation to its holding or group financing and licensing functions;
- 10 The Dutch company has (for at least 24 months) office space at its disposal in the Netherlands which is used to carry out its holding, financing or licensing functions.

The substance requirements stated above are rather easy to fulfil, especially since no relation to the size of the companies has to be demonstrated. This is also put forward by Dutch consultancy firms as one of the main attractions of the Dutch fiscal system to set up conduit structures: *"Foreign investors with a holding company in the Netherlands, with no business presence because they have no office/staff can be supported by a Dutch financial service provider / company (trust), so they will be seen as Dutch tax resident"*.⁸⁵ The weakness of the requirements is also showcased by a specific example outlined in chapter 7.

84 Buren (2018). New Dutch substance requirements published. URL: <https://www.burenlegal.com/en/news/new-dutch-substance-requirements-published>

85 MFFA (2016). Substance requirements in the Netherlands, <https://www.mffa.nl/netherlands-tax-advice/substance-requirements-in-the-netherlands/?lang=en>

4.2.2 Participation exemption

The participation exemption is often seen as “one of the most important provisions of Dutch corporate income tax legislation”.⁸⁶ It aims to avoid economic double taxation by ensuring that profits within a corporate group are taxed only once. Foreign profits are exempt from Dutch CIT when they are distributed to the parent company in the Netherlands. This means in international tax avoidance terms, when money is shifted from source countries to tax havens via the Netherlands, the income being routed through the Netherlands is not taxed at the level of the Dutch subsidiary. To qualify for the participation exemption, the Dutch company and its foreign subsidiary have to meet certain requirements: the Dutch company has, for example, to hold at least five per cent of the shares of the foreign subsidiary. However, the participation exemption, with its intention to avoid economic double taxation, can lead to the opposite: double non-taxation.⁸⁷

4.2.3 Tax treaties

As said above, the extensive network of tax treaties the Netherlands maintains with almost 100 countries worldwide is central to the Dutch tax regime. The treaty network enables firms with affiliates in countries that have a treaty with the Netherlands to move passive income payments, such as dividends, interest, royalties and capital gains from a subsidiary in one country to a (parent) company in another country through an entity in the Netherlands, which can be a mailbox company. Treaties can also lead to capital gains income being allocated to the Dutch mailbox company, where it is not taxed because of the participation exemption.⁸⁸

4.2.4 No withholding taxes on outgoing payments

Under Dutch tax law, there is no WHT on interest and royalty payments that are paid from a Dutch subsidiary to another foreign entity, and exemptions only apply for the 15 per cent dividend WHT laid down in statutory law if certain conditions are met.⁸⁹ As mentioned before, there are plans to introduce, from 2021 onwards, a conditional intra-group WHT on interest and royalty payments,

86 Netherlands Foreign Investment Agency (NFIA), *Why Invest in Holland?* (March 2018).

Available at https://investinholland.com/nfia_media/2018/03/FLYER-tax-and-incentives-2018_Mar18_DEF.pdf

87 From 2019 onwards so-called ‘Controlled Foreign Companies’ rules are introduced for Dutch companies. Those rules intend to prevent profit shifting from to intra-group entities in low-tax jurisdictions. However, the same (weak) substance requirements from the aforementioned box 1 are applicable for the foreign affiliated companies. Whenever the substance requirements are fulfilled, the CFC rules will not be applied.

88 See SOMO (2013) *Should the Netherlands sign tax treaties with developing countries?* available at <https://www.somo.nl/should-the-netherlands-sign-tax-treaties-with-developing-countries/> for analysis of the Dutch treaty network.

89 Tax Consultants (2018). *The Dutch dividend withholding tax exemption broadened*, 19 January 2018, <https://www.tax-consultants-international.com/read/the-dutch-dividend-withholding-tax-exemption-broadened-2018-?sublist=5990&submenu=16955>

but it will only apply to the so-called ‘low-tax jurisdictions’ or countries on the EU list of non-cooperative jurisdictions in taxation matters. Therefore, it will only target some practices of tax treaty shopping.⁹⁰

4.2.5 Tax rulings (advance agreements between the revenue authority and large taxpayers)

Companies can request a tax ruling from the Dutch Tax Authority – an Advanced Pricing Agreement (APA) or an Advanced Tax Ruling (ATR) – which, according to the government, provides companies with “certainty beforehand” on the application of the law regarding their circumstances in the Netherlands.⁹¹ The rulings are agreements between companies and the government on the size of their corporate tax base and to what extent their corporate profits will be taxed in the Netherlands. In 2017, the Dutch government provided about 500 of these rulings.⁹² Neither the public nor Parliament knows which companies have a ruling in the Netherlands.⁹³ The rulings have caused controversy in the Netherlands (and the EU) for a number of years, exacerbated by decisions taken by the European Commission to investigate certain rulings, as they might be deemed illegal under EU state aid rules.⁹⁴ The Netherlands Foreign Investment Agency (a government investment promotion agency, part of the Ministry of Economic Affairs) states the possibility of obtaining a ruling “is one of the most attractive features of Dutch tax law. The aim of the Dutch tax ruling policy is to attract international investors to the Netherlands”.⁹⁵

In November 2018, following consultation, the Dutch Secretary of State of Finance proposed changes to its tax rulings practice⁹⁶ to create more transparency in the issuance of international

90 This is also explained in a recent briefing by the Dutch Bureau for Economic Policy Analysis: CPB (2019). ‘Conduit country the Netherlands in the Spotlight’, Arjan Lejour, Jan Möhlmann & Maarten van ‘t Riet, CPB Policy Brief January 2019, URL: https://www.cpb.nl/sites/default/files/publicaties/download/cpb-discussion-paper-290-ranking-stars_0.pdf

91 Dutch Tax Authority, website: ‘Vooroverleg/Ruling’, https://www.belastingdienst.nl/wps/wcm/connect/bldcontentnl/standaard_functies/prive/contact/rechten_en_plichten_bij_de_belastingdienst/ruling/ (accessed 29 April 2019).

92 See Dutch Tax Authority, ‘Factsheet Rulings’: <https://belastingdienst-in-beeld.nl/themas/belastingheffing-en-internationale-structuren/factsheet-rulings/> (accessed 24 January 2019).

93 Until very recently, there was no information available on the content of the rulings. However, through freedom of information requests, there is now some limited information on the kind of corporate structures that are subject to the rulings. See: SOMO, ‘Structures of secret Dutch tax rulings revealed’, 9 May 2017, available via <https://www.somo.nl/structures-secret-dutch-tax-rulings-detail-revealed/>

94 According to the Commission, the ruling between the Dutch government and Starbucks is not in line with EU law, see: European Commission, ‘Commission decides selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU state aid rules’, press release 21 October 2015, available via http://europa.eu/rapid/press-release_IP-15-5880_en.htm

95 NFIA, ‘Why Invest in Holland? Incentives & Taxes in the Netherlands 2018’, available at https://investinholland.com/nfia_media/2018/03/FLYER-tax-and-incentives-2018_Mar18_DEF.pdf

96 DLA Piper (2018). Dutch government announces stricter requirements for issuance of tax rulings, global tax alert, <https://www.dlapiper.com/en/france/insights/publications/2018/11/dutch-government-announces-stricter-requirements-for-issuance-of-tax-rulings/>

tax rulings. This was presented to Parliament, in April 2019 in a letter from the Dutch Secretary of State of Finance to the Dutch Parliament⁹⁷:

1. The Dutch Tax Authority will publish a redacted summary of all international tax rulings it issues.
2. The Dutch Tax Authority will publish an annual report relating to all international tax rulings.
3. Independent experts will continue to annually investigate whether the issued rulings are lawful and in accordance with Dutch tax law.

In the letter of November 2018, the Secretary of State proposed further plans to target tax avoidance structures in the Netherlands. The four main proposals are the following:

1. Impose stricter requirements for companies that apply for an international tax ruling. It will no longer be sufficient for a company to only comply with the Dutch minimum substance requirements. Instead, companies will need to have a physical presence (“economic nexus”) in the Netherlands.
2. The Dutch Tax Authority will examine more closely the purpose of the request. Rulings will no longer be issued if the sole purpose is to reduce Dutch or foreign taxes. This new rule also applies to transactions with companies based in low-tax jurisdictions or resident in a jurisdiction on the European Union’s blacklist. Low-tax jurisdictions have a statutory corporate tax rate lower than nine per cent.
3. All international tax rulings will have a maximum term of five years. The five-year term can be extended to 10 years only in exceptional cases.
4. There will be a fixed format for all international tax rulings.

As these reforms still have to be discussed and implemented by the Dutch Parliament it is still uncertain what the ultimate outcome and impact will be. Increased transparency around tax rulings will, furthermore, not in itself lead to a reduction in the use of the Netherlands as a conduit country.

4.2.6 Fiscal unity

The Dutch tax regime offers the possibility to set up a fiscal unity that includes at least two companies within the same group. This allows for tax consolidation, offsetting losses and profits within the fiscal unity. Importantly, within a fiscal unity no CIT is levied when assets are transferred from one company to another.

4.2.7 Corporate legal forms

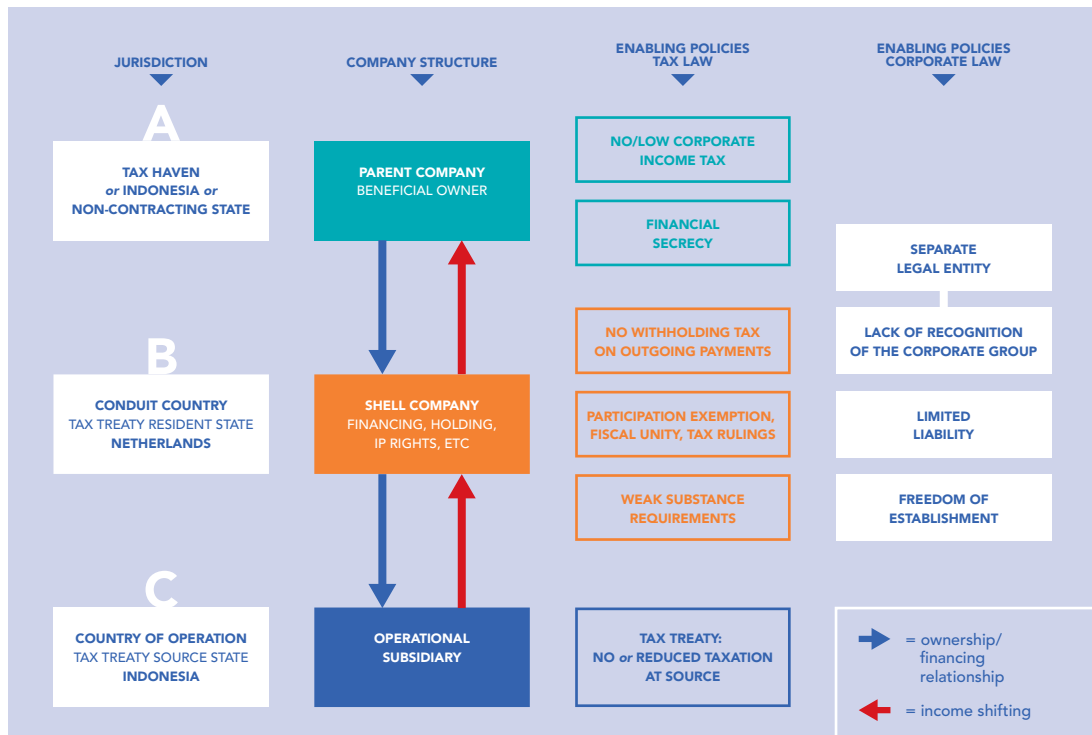
A multitude of corporate legal forms in Dutch law give tax benefits to corporations. The most common corporate legal form is the private limited liability company (‘besloten vennootschap’ or ‘BV’), comparable to a similar limited liability form in many other countries. In addition to the BV, the report will highlight two other legal forms used for tax abuse, although not often, in the Dutch-Indonesian perspective. One commonly used legal form is the cooperative (‘coöperatief’) that has members instead of shareholders. Under certain circumstances, no dividend tax is paid

97 Ministerie van Financiën (2019). Kamerbrief beleid vernieuwde rullingpraktijk. URL: <https://www.rijksoverheid.nl/documenten/kamerstukken/2019/04/23/kamerbrief-beleid-vernieuwde-rullingpraktijk>

on the profit distribution to its members.⁹⁸ Another legal form that has come under scrutiny because of widespread tax abuse by (foreign) corporations is the limited partnership ('commanditaire vennootschap').⁹⁹ US corporations, in particular, have used this legal form to avoid taxes in both the Netherlands and the US. Certain anti-abuse measures have been designed to tackle the abuse of both legal forms, such as the EU 'Anti-Avoidance Directive II', which is planned to take effect in 2020 and will be discussed in Dutch Parliament in 2019.

In summary, tax policies and treaties enable shifting of income between jurisdictions at low or no taxation, and corporate law promotes the setting up and disbanding of companies at low cost and without transparency, physical presence or legal liability for beneficial owners allowing corporations to use a global network of jurisdictions in their tax minimisation structures. This is illustrated schematically in Figure 6 below.

Figure 6 Dutch conduit structure



Source: authors

98 For more information, see here: Tax Consultants International, 'Incorporation of a Dutch Cooperative' (15-03-2017), https://www.tax-consultants-international.com/read/Incorporation_Dutch_Cooperative

99 Various ways of abuse have been reported by media and others, see here for an overview: Francis Weyzig, 'End the abuse of Dutch limited partnerships!' 14 April 2016 (blog post), available via <https://francisweyzig.com/2016/04/14/end-the-abuse-of-dutch-limited-partnerships/>

4.3 Tax treaty policy of the Netherlands

Understanding the extensive network of Dutch tax treaties is central to understanding the role of the Netherlands as a tax haven or conduit country. In the context of this research report, it is relevant to briefly discuss the government's policy and perspectives on tax treaties.

The 'Notitie Fiscaal Verdragsbeleid 2011' (updating previous policy notes of 1987, 1996 and 1998) contains a summary of the principles and guidelines of the Dutch government's position regarding treaty negotiations.¹⁰⁰ It states that the Netherlands, while using the OECD treaty model as its basis, also allows room for flexibility by its willingness to adapt any treaty to specific features of the potential treaty partner. With regard to developing countries, the policy note states that the government would be willing to follow certain elements of the UN model treaty instead of the OECD model treaty, including a longer period for the recognition of permanent establishments and "relatively high" WHT rates.¹⁰¹ The Secretary of State of Finance has announced that 'Notitie Fiscaal Verdragsbeleid' will be updated in 2019.

In 2013, the Dutch government announced that it would renegotiate the treaty between Zambia and the Netherlands, and would offer 23 developing countries the opportunity to include anti-abuse measures in their bilateral tax treaties.¹⁰² The following countries took the opportunity to include an anti-abuse measure in their tax treaty with the Netherlands: Ethiopia, Ghana, Kenya, Malawi, Ukraine, Uzbekistan and Zambia. The government has furthermore announced that it has agreed with several countries, including Indonesia, to include anti-abuse measures in treaties through the Multilateral Tax Convention.¹⁰³

In 2017, both the Netherlands and Indonesia signed the Multilateral Tax Convention, which allows for an anti-abuse provision to be added to the DTA following mutual agreement on a specific provision.¹⁰⁴ The Convention has been ratified by the Netherlands in March 2019.¹⁰⁵ At the time of writing, the Indonesian government still had to submit the Convention to the Indonesian Parliament for approval.

100 Rijksoverheid, 'Notitie Fiscaal Verdragsbeleid 2011' 11 February 2011, https://www.eerstekamer.nl/behandeling/20110211/_fiscaal_verdragsbeleid_nfv

101 Tweede Kamer der Staten-Generaal, Vergaderjaar 2015-2016, Kamerstuk 34431, Nr. 2, Verslag van een Schriftelijk Overleg, 11 April 2016 (Government replies to Parliamentary questions on the 2015 Protocol), <https://zoek.officielebekendmakingen.nl/dossier/34431/kst-34431-2?resultIndex=0&sorttype=1&sortorder=4>

102 Rijksoverheid, 'Kabinetsreactie op SEO-rapport Overige Financiële Instellingen en IBFD-rapport ontwikkelingslanden', 30 August 2013, available via <https://www.parlementairemonitor.nl/9353000/1/j9vvij5epmj1ey0/vjczkds2b0yf>

103 The other countries are: Egypt, Georgia, India, Indonesia, Nigeria and Pakistan.

104 OECD (2019). Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS. URL: <https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>

105 OECD (2019). The Kingdom of the Netherlands and Georgia deposit instruments of acceptance or ratification for the Multilateral BEPS Convention. URL: <https://www.oecd.org/ctp/treaties/the-kingdom-of-the-netherlands-and-georgia-deposit-instruments-of-acceptance-or-ratification-for-the-multilateral-beps-convention.htm>

4.4 The 2015 Protocol and OECD BEPS Multilateral Tax Convention

The widespread practice of treaty shopping using the Indonesia-Netherlands DTA, as shown in this research, has not yet led to a serious reform of the treaty. Indonesia has laid down beneficial ownership criteria for foreign receivers of income in an effort to combat Dutch conduit arrangements.

The term ‘beneficial owner’ is used in Articles 10, 11 and 12 of the Indonesia-Netherlands DTA, referring to interest, dividend and royalty payments. This means that the reduced withholding tax is only used when the recipient of these payments is indeed the beneficial owner and a resident of either the Netherlands or Indonesia. While the concept of beneficial ownership is central to tackling treaty abuse, it lacks a clear definition in both treaties and the majority of domestic laws, and is thus subject to endless debates among tax practitioners in the Organisation for Economic Cooperation and Development (OECD). Indonesia’s attempt to clarify the definition in a regulation¹⁰⁶, triggered criticism from companies and the Dutch government who claimed that it constituted a treaty override and created legal uncertainty. It was this criticism that contributed to the renegotiation of the Indonesia-Netherlands DTA in 2015.¹⁰⁷

On 30 July 2015 the Netherlands and Indonesia signed an amending protocol (hereafter 2015 Protocol) to the 2002 Indonesia-Netherlands DTA (hereafter 2002 DTA), which, among other things, increased the maximum WHT rate on non-government related interest payments on loans for two years or loans related to sales credit of industrial, commercial or scientific equipment from zero per cent to five per cent. This is however still among the lowest of all Indonesia’s tax treaties¹⁰⁸ and still substantially reduces revenue due in Indonesia.¹⁰⁹

According to the Dutch Ministry of Finance,¹¹⁰ the Dutch government approached the Indonesian government with the proposal to negotiate an anti-abuse provision in the treaty but the Indonesian government preferred not to include, arguing that renegotiations for a new Protocol were already underway, and that an anti-abuse provision required a separate procedure.

106 Orbitax (2005). Indonesia – Netherlands. URL: <https://www.orbitax.com/news/archive.php/The-Indonesian-Director-Genera-964>

107 Tweede Kamer der Staten-Generaal, Vergaderjaar 2015-2016, Kamerstuk 34431, Nr. 2, Verslag van een Schriftelijk Overleg, 11 April 2016 (Government replies to Parliamentary questions on the 2015 Protocol), <https://zoek.officielebekendmakingen.nl/dossier/34431/kst-34431-2?resultIndex=0&sorttype=1&sortorder=4>

108 PWC pocket tax book Indonesia – 2018: <https://www.pwc.com/id/en/pocket-tax-book/english/ptb-2018-eng.pdf> (accessed on 29th January 2019).

109 After completion of domestic ratification procedures by both countries, the protocol enters into force on 1 August 2017 and will be effective as of 1 October 2017. Changes to withholding tax rates will apply as of that date. Loyens & Loeff (2017). Revised Netherlands-Indonesia Tax Treaty becomes effective on 1 October 2017. URL: <https://www.loyensloeff.com/en-us/news-events/news/revised-netherlands-indonesia-tax-treaty-becomes-effective-on-1-october-2017>

110 Letter from the Dutch State Under-Secretary E. Wiebes to the Dutch Parliament (8th of June 2015): <https://zoek.officielebekendmakingen.nl/kst-25087-102.html> (accessed 31st January 2019).

These bilateral treaty negotiations took place in parallel with the recent development of the ‘Multilateral Tax Convention to implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting’. The Convention is open for signing by all countries and was drafted, in large part, as a response to the recognised wide-spread abuse of tax treaties.

Box 2 Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS

In 2012, the G20 recognised that what is now termed Base Erosion and Profit Shifting (BEPS) undermines “the fairness and integrity of our tax systems”, and defined BEPS as “instances where the interaction of different tax rules result in tax planning that may be used by MNEs to artificially shift profits out of the countries where they are earned, resulting in very low taxes or even double non-taxation.”¹¹¹ In 2013, in response to a corresponding G20 mandate, the OECD published a comprehensive Action Plan developed with G20 members aimed at addressing BEPS, which also calls on OECD countries “to examine how their domestic tax laws contribute to BEPS and to ensure that international and domestic tax rules do not allow or encourage MNEs to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions.”¹¹²

Action 15 proposes a Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS. As the name suggests, the Multilateral Convention, termed by the Multilateral Instrument (MLI)¹¹³ aims to modify and implement changes to existing tax treaties to tackle aggressive tax planning by MNEs. The Convention is open for all countries to join and “formulated so that it can apply to all tax treaties, whether based on the OECD or the United Nations (UN) model, or indeed another.” Indonesia is a full member of the OECD’s BEPS project and took part in the Ad Hoc Group of states that developed the BEPS Multilateral Tax Convention.

On 7 June 2017, the Netherlands and Indonesia joined 67 countries in signing the BEPS Multilateral Tax Convention¹¹⁴, although the MLI has not yet been ratified by Indonesia. The MLI will allow for an anti-abuse provision to be added to the Indonesia-Netherlands DTA. The implementation of the MLI enables countries to meet the minimum standards and provisions, in relation to tax treaties, as put

111 G20 (2013), Tax Annex to the St. Petersburg G20 Leaders’ Declaration, p. 3. For this and other summit documents, see <https://www.oecd.org/g20/summits/saint-petersburg/>

112 BEPS Monitoring Group (March 2017). Explanation and Analysis of The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MC-BEPS), <https://bepsmonitoringgroup.wordpress.com/2017/03/16/the-multilateral-convention-on-beps/>, p. 1.

113 See OECD website: <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>

114 For a current list of signatories and their various positions, see <http://www.oecd.org/tax/treaties/beps-ml-signatories-and-parties.pdf>

forward with the BEPS program. Under the provisions of the Convention, each jurisdiction is required to provide a list of reservations and notifications (the “MLI Positions”) at the time of signature as well as a list of Covered Tax Agreements, i.e., tax treaties to be amended through the MLI. Articles 6¹¹⁵ and 7 of the BEPS Tax Convention aim at ensuring a minimum level of protection against treaty shopping. Article 7 advises states to implement one of the following three anti-abuse provisions:

1. Principal Purpose Test (PPT),
2. a PPT plus a simplified limitations on benefits (LOB) provision, or
3. a detailed LOB provision plus an anti-conduit arrangement.

Both the Netherlands and Indonesia have opted for the PPT.¹¹⁶ The Dutch State Secretary for Finance has, furthermore, stated that the Netherlands is also willing to apply the LOB procedure, although only on a bilateral basis.¹¹⁷

Differences between the PPT and the (S)LOB

There are many differences between the PPT and the LOB provision. One of the main differences is the simplicity of the PPT versus the complexity of the LOB provision. The PPT aims at denying treaty benefits “when it can reasonably be concluded that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit”.¹¹⁸ The LOB limits treaty benefits to companies with sufficient presence in the relevant country, based on their legal nature, ownership and activities. These objective tests have the effect of adding additional requirements for a person to be entitled to the benefit of the treaty. While the PPT is more straightforward, it gives more room for subjectivity, while the LOB has a more objective character. The LOB is furthermore relatively detailed and hence complex, making it less attractive for tax revenue authorities with (already) limited resources, which is the case in most developing countries. This was one of the main reasons to aim for a simplified version of the LOB (hence SLOB). As the name indicates, the SLOB test is less complex. It provides several hurdles/tests that a taxpayer has to take in order to secure its application for the tax treaty benefits. For the application of tax treaty benefits, investors, for example, have to meet the ‘qualified person’ criteria or has to prove that it is engaged in “active conduct or trade or business”. Furthermore, states that apply the SLOB can apply a treaty benefit by looking through the fund to determine whether at least 75% of its investors

115 Which includes in the preamble to every DTA as part of the minimum standards that the DTA intends to eliminate double taxation with respect to taxes covered by the DTA without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty shopping arrangements aimed at obtaining reliefs provided in the CTA for the indirect benefit of residents of third jurisdictions). OECD (2016). Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS. Article 6. Page 8. URL: <https://www.oecd.org/ctp/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beeps.htm>

116 At the time of signature Indonesia opted for the simplified LOB. However, based on information from the Ministry of Finance Indonesia changed its MLI position to the Principal Purpose Test.

117 Parliamentary debate ‘Voorkoming grondslaguitholling en winstverschuiving, 2019D05014 (February 6th 2019). URL: <https://www.tweedekamer.nl/kamerstukken/detail?id=2019D05014&did=2019D05014>

118 OECD (2016). MULTILATERAL CONVENTION TO IMPLEMENT TAX TREATY RELATED MEASURES TO PREVENT BASE EROSION AND PROFIT SHIFTING, pp. 8-9. URL: https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=2ahUKewjGg4WpxO3hAhWxM-wKHYYX-C_0QFjAAegQIBBAC&url=https%3A%2F%2Fwww.oecd.org%2Ftax%2Ftreaties%2Fmultilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf&usq=AOvVaw2MjmkHqGYZmxdmh2vGaQt2

are equivalent beneficiaries, in which case, the investors in the fund are not deemed to be using the fund structure to achieve better tax results.¹¹⁹

A specific problem, that is apparent for both the PPT as the SLOB is the difficulty for the source state to obtain the necessary information to demonstrate tax treaty abuse. As the necessary information to demonstrate treaty abuse has to be provided by the resident state, the ability of the source state is constrained by the willingness and ability of the resident state to provide the necessary information.

The concept of Beneficial Ownership

Beneficial ownership is an important concept used in double tax treaties. It is used to define whether a receiver of a cross border payment of passive income (interest, royalties, and dividends) can benefit from the treaty benefits and privileges. There is however no fixed definition of beneficial ownership and some treaties refer to domestic legislations while others refer to OECD commentaries on the concept.¹²⁰ The concept is of great importance and significance as an anti-abuse instrument, especially in accordance with the rise of (international) tax planning structures. The OECD commentaries can be summarized as follows:¹²¹

- ❑ The concept of beneficial ownership does not take its meaning from domestic law or other OECD instrument, but rather has an autonomous treaty meaning;
- ❑ The intention of the beneficial ownership concept was to clarify the use of the words “paid to...a resident” in the Model and so should be read in that context;
- ❑ Beneficial owners are those that have the right to use and enjoy the payment unconstrained by contractual or legal obligations to pass the payment on. Essentially meaning that persons acting as fiduciaries, agents and nominees are not beneficial owners;
- ❑ Use and enjoyment of property that derives the income is distinguished from the legal ownership of the property; and
- ❑ An obligation to pass payments on can be contractual or can be found to exist on the basis of facts and circumstances.

The commentaries, however, leave room for interpretation on the application of the concept. It is therefore dependent on the national authorities how the concept of beneficial ownership will be defined and used to counter treaty shopping. A further complicating factor in the functioning of beneficial ownership in countering tax treaty abuse is the inclusion of additional anti-treaty abuse measures along with the MLI, such as the PPT and the (S)LOB.¹²²

119 Brown Brothers Harriman (2017). IN FOCUS – Learning to play a multilateral instrument. URL: <https://www.bbh.com/en-us/insights/in-focus---learning-to-play-a-multilateral-instrument-23634>

120 Demin, A.V. & Alexey V. Nikolaev (2019). The Beneficial Owner Concept in the Context of Beps: Problems and Prospects *Financial Law Review*, 2019, Issue 13 (1), p. 1-14.

121 United Nations Committee of Experts on International Cooperation in Tax Matters (2019). Update of the UN Model Double Taxation Convention between Developed and Developing Countries -Beneficial Ownership.

122 Blum, D.W. (2017). Treaty shopping and prevention in a post-BEPS world: Part I. *International Tax Report*. URL: <https://www.internationaltaxreport.com/investment-and-indirect-taxes/treaty-shopping-and-prevention-in-a-post-beps-world-part-i-126400.htm>

5 The Indonesia-Netherlands tax treaty and Indonesian tax law

This chapter describes and analyses the changes in the Indonesia-Netherlands DTA since it was first signed in 1973 until the present (Chapter 5.1), as well as Indonesia's tax law and court system (Chapter 5.2). So far, there have been four amendments (including one termination and full renegotiation) of the treaty, referred to here as DTA 1973, DTA 1993 (the 1991 Protocol is not included here), DTA 2002, and the most recent amendment by a Protocol, DTA 2015. This section also discusses the DTA 2015 amendments which, importantly, increase the WHT on interest for specific loans from zero per cent to five per cent. This improves some source taxation rights, but fails to address other problems identified in tax dispute analysis.

5.1 History of the Indonesia-Netherlands tax treaty

The Indonesia-Netherlands DTA was signed on 5 March 1973, and became formally effective at the end of 1974 (hereinafter referred to as DTA 1974). The first renegotiation of the treaty took place in the early 1990s, resulting in a signed protocol in 1991 and a protocol amendment on 5 March 1993. This Protocol was then ratified on 3 May 1994 and became effective on 1 January 1995 (hereinafter referred to as DTA 1993).

In March 2000, the Government of Indonesia submitted a memorandum of termination of the Indonesia-Netherlands DTA to the Dutch Government through its embassy in Jakarta, resulting in the treaty no longer being applicable from 1 January 2001 onwards. Both parties agreed, however, to continue applying the treaty, until the new treaty came into force. The official reason Indonesia gave for terminating the DTA was that it restricted the country from levying Branch Profit Tax (BPT), used by contractors of Production Sharing Contracts (PSC) in the upstream oil and gas industry.¹²³

123 Ministry of Foreign Affairs (2002). Verdrag Nederland, Indonesië tot vermijden dubbele belasting en voorkomen van ontgaan van inkomstenbelasting; 29-1-2002; Brief minister ter aanbieding bovengenoemd verdrag, ter stilzwijgende goedkeuring, 28417 nr. 1;376. URL: <https://zoek.officielebekendmakingen.nl/kst-28417-1>

Box 3 Branch Profit Tax in Production Sharing Contracts in the DTA 2002

Production sharing agreements or contracts (PSCs) is a common type of contract signed between a government and a resource extraction company. They state how much of the resource can be extracted from the country, and how much of the profits from sale each party will receive. Profits made under PSCs are subject to Corporate Income Tax as well as an additional Branch Profit Tax (BPT).

Corporate Income Tax is paid on the income of a (domestic or foreign) capital investment company or a permanent establishment (PE) through which a foreign parent company operates its upstream oil and gas business activities in Indonesia.¹²⁴

Under Article 26(4) of the Income Tax Law, after-tax profits of a permanent establishment are subject to an additional withholding tax of 20 per cent, known as branch profit tax (BPT). Branch Profit Tax is tax imposed on the income of a permanent establishment, after Corporate Income Tax deduction, which is to be repatriated as profit to the parent company in the foreign country.

To ensure that tax treaty provisions do not affect the government's percentage of profit share in product sharing contracts, Indonesia reserves the right to apply Branch Profit Tax relating to oil and gas or contracts of work in other mining sectors. Because this can conflict with tax treaties based on the OECD Model, specifically the non-discrimination article, Indonesia ensures its applicability through a special provision in Article 10 (dividends) of a DTA that allows the Branch Profit Tax to override tax treaty provisions.

The Indonesian and Dutch government renegotiated and agreed upon a new version of the DTA on 29 January 2002, which became enforceable on 31 December 2003 and effective as of 1 January 2004 (hereafter referred to as DTA 2002).¹²⁵ The DTA 2002 set the BPT rate at 10 per cent, a minor improvement from the 9 per cent that applied under the 1993 treaty.¹²⁶ The WHT on outgoing dividends was decreased to 10% and the WHT on outgoing interest on specific loans was abolished.¹²⁷ This caused the new DTA to be abused widely for treaty shopping, causing revenue losses in Indonesia. The renegotiation for the 2002 treaty therefore did not improve the country's ability to raise taxes, but actually led to further erosion of Indonesia's tax base. See chapter 7 for an example of how an Indonesian company abused the 2002 tax treaty.

124 SSEK Indonesian Legal Consultants (February 7th 2018) 'Tax Treatment for Gross Split Production Sharing Contracts in Indonesia's Oil and Gas Sector', <https://www.lexology.com/library/detail.aspx?g=24f06238-02f1-40e2-9bd8-21272070b97e>

125 The official text of the DTA 2002, can be found here (in Dutch): <http://wetten.overheid.nl/BWBV0001619/2017-08-01#Verdrag>

126 Ministry of Foreign Affairs (2002). Verdrag tussen de regering van het Koninkrijk der Nederlanden en de regering van de Republiek Indonesië tot het vermijden van dubbele belasting en het voorkomen van het ontgaan van belasting met betrekking tot belastingen naar het inkomen, met Protocol; Jakarta, 29 januari 2002 (in Dutch): <https://zoek.officielebekendmakingen.nl/kst-28417-1.html>, accessed on January 29th, 2019.

127 Loans with a term of at least two years or a loan related to sales credit of industrial, commercial or scientific equipment.

To curb this abuse of the tax treaty, Indonesia unsuccessfully attempted to take unilateral measures (see chapter 5). This ultimately led to further renegotiations and an amended protocol that was signed on 30 July 2015 (hereafter referred to as DTA 2015).¹²⁸ This Protocol became enforceable on 1 August 2017 and effective from 1 October 2017. While the amending protocol increased some WHT rates, the Dutch-Indonesian DTA was still considered to be very favourable, as demonstrated by the following commentaries of tax consultancy firms.

Ernst & Young write: *“While not as favourable as the current [0%] rate, this [5%] is still the lowest interest WHT rate agreed upon by Indonesia in its international tax treaties. The Netherlands does not levy WHT on outgoing interest payments.”*¹²⁹

Loyens & Loeff similarly advertise: *“The revised tax treaty provides for, inter alia, withholding tax (“WHT”) rates which are the lowest available. The revised Indonesia-Netherlands DTA is one of the most attractive and competitive tax treaties entered into by Indonesia and provides a clear opportunity when making inbound investments into Indonesia.”*¹³⁰

Table 2, below, displays the most important differences and changes over time in the definition of ‘permanent establishment’ (PE), and regarding the WHT rates on dividends, interest and royalties. The changes in PE criteria provide a flexible threshold that allows Dutch investors not to be taxed in Indonesia while lowering WHT rates benefits corporations and resident states, but limits the taxing rights of source countries (as explained in Chapter 3). Importantly, the Protocol still does not include an anti-abuse provision.

Table 2 Changes between DTA 1973, DTA 1993, DTA 2002, Protocol 2015¹³¹

Amendments	DTA 1973	DTA 1993	DTA 2002	DTA 2015
Threshold of PE criteria in the construction sector	183 days	6 months	6 months	6 months
Threshold of PE criteria in the service sector	183 days	3 months	3 months	3 months
Withholding tax rate on dividend:				
- Share ownership of at least 25% (Substantial holdings)	0%	10%	10%	5%
- Share ownership <25% (Portfolio)	20%	15%	10%	15%
Withholding tax rate on interest:	20% / 10%	0% / 10%	0% / 10%	10% / 5%
Royalties	20% / 10% / 5%	10%	10%	10%
Branch Profit Tax	n.a.	9%	10%	10%

128 The text of the 2015 Protocol can be found here: <https://zoek.officielebekendmakingen.nl/trb-2015-121.html>. Ratified by Indonesian parliament on 30 July 2017 and effectively implemented with President Regulation 24/2017 on 6 March 2017.

129 EY Global Tax Alert (14 August 2015). “Indonesia and the Netherlands sign new Protocol to existing tax treaty”, <http://www.ey.com/gl/en/services/tax/international-tax/alert-indonesia-and-the-netherlands-sign-new-protocol-to-existing-tax-treaty>

130 Loyens & Loeff news (5 July 2017). “Revised Netherlands-Indonesia Tax Treaty becomes effective on 1 October 2017”, <https://www.loyensloeff.com/en-us/news-events/news/revised-netherlands-indonesia-tax-treaty-becomes-effective-on-1-october-2017>

131 For elaboration on the specific rates mentioned, see table 10 in the appendix.

In addition to the above changes, the acknowledgement of the territory of the Republic of Indonesia¹³² provides further legal certainty by stating that economic activities, such as offshore oil and gas drilling conducted in waters within its territory, are taxable by Indonesia.

Looking in particular at the most recent amendments made to the treaty by the Protocol of 2015, a few important changes¹³³ should be mentioned:

- ▣ The WHT rate on dividends is reduced from 10 per cent to five per cent in case the recipient is a Dutch company holding at least 25 per cent of the shares in the capital of the Indonesian company.
- ▣ The WHT rate on interest in case of a loan with a term of at least two years or a loan related to sales credit of industrial, commercial or scientific equipment is raised to five per cent, replacing the previous WHT of zero per cent.
- ▣ No mutual agreement on the mode of application of Articles 10, 11 and 12, relating to dividends, interest and royalties, is anymore necessary.
- ▣ A clause regarding the exchange of information was strengthened and brought in line with Article 26 of the OECD Model Convention (2014)¹³⁴.
- ▣ Clauses regarding assistance in the collection of taxes (article 28A) (for tax claims over € 1,500) stipulate that a contracting state may not decline to supply information solely because it has no domestic interest in such information, or because it is held by a bank, other financial institution, nominee or person acting in an agency or fiduciary capacity, or because it relates to ownership interest in a person.
- ▣ Regarding the Indonesian Circular from 2009 on beneficial ownership (which the Netherlands says defined beneficial ownership more narrowly than the OECD and UN Model Commentaries), Indonesia and the Netherlands agreed to now interpret the term “beneficial owner” in accordance with the interpretation and commentaries provided by the OECD.

Thus the 2015 Protocol grants five per cent more taxation rights to the source country (Indonesia) on interest on specific loans, being still significantly lower than more common WHT rate of 10 per cent on non-government related interest payments included in other Indonesian tax treaties. The Netherlands has however claimed that, as of 2011, it would allow for higher withholding tax rates in treaties with developing countries, but states that in this case the agreed rates “fit within this framework”.¹³⁵ Capital gains tax (Article 14) from the sale of property or shares in Indonesia can still be easily avoided using a Dutch conduit entity, as the disputes regarding the definition of ‘beneficial owner’ or ‘permanent establishment’ show. Importantly, the protocol does not contain an (S)LOB clause,

132 Based on the concept of an archipelagic state, as defined in the 1991 Protocol to the 1982 UN Convention on the Law of the Sea.

133 Netherlands; Indonesia – Protocol to treaty between Indonesia and Netherlands – details (19 Aug. 2015), News IBFD.

134 OECD (2004). Changes to the Model Tax Convention, <http://www.oecd.org/tax/treaties/33614065.pdf>

135 Tweede Kamer (2016) Verslag Schriftelijk Overleg, Kamerstuk 34 431, nr. 2, p. 6.

a PPT or any other general anti-treaty shopping provisions. Since 2013 the Dutch government claims it has attempted to renegotiate tax treaties with 23 developing countries, including Indonesia, with the purpose of including anti-abuse measures.¹³⁶ However, the revised treaty with Indonesia does not include anti-abuse measures, which the Netherlands states was because Indonesia preferred to discuss the inclusion of anti-abuse measures in a separate process.¹³⁷

5.2 Indonesia's tax law system

To give context to the above-mentioned legal disputes and the analysis of the court cases in the following subchapter, this section explains the legal basis of Indonesia's tax law system. The DGT has used Circular Letters and Regulations in their interpretation of certain provisions in the Indonesia-Netherlands DTA which were generally rebuffed by the Tax and Supreme Courts as not having sufficient legal basis. Current reform proposals regarding the definition of PE or beneficial ownership should also be seen in this light.

In the first instance, the 1945 constitution of Indonesia acts as the country's legal basis. The Supreme Court (*Mahkamah Agung*)¹³⁸ is the main authority in upholding Indonesian law and acts as the final court of appeal, overseeing the regional high courts. To ensure that the lower courts maintain their quality and performance in their respective functions, the Supreme Court issues advice via Supreme Court Circulars (*Surat Edaran Mahkamah Agung*).¹³⁹

In 1915, Indonesia established a Tax Review Tribunal (*Institusi Pertimbangan Pajak*), renamed Tax Dispute Settlement Board in 1997 (*Badan Penyelesaian Sengketa Pajak*).¹⁴⁰ In 2002, the Government issued a Tax Court Law (No. 14 /2002), which defined the Tax Court as a special Chamber of the Administrative Court and put it under the direct control of the Supreme Court. The Ministry of Finance conducts the organisational, administrative and financial management of the Tax Court and influences the appointment of Tax Court judges made by the President by providing the President with a list of candidates, which have to be approved by the Head of the Supreme Court.

This new structure has given the Tax Court judiciary powers. The management of the Tax Court, however, falls under both the Supreme Court (judicial and technical matters) and the Ministry of Finance (administrative, organisational and financial matters). This raises questions as to whether the Tax Court can be independent from political considerations and has led to demands for its reform (see Box 4).

136 Ibid., p. 9.

137 Ibid., p. 7.

138 State Gazette 1965 No. 75; Undang Undang tentang Pengadilan dalam Lingkungan Peradilan Umum dan Mahkamah Agung.

139 Through the Circulars, the Supreme Court influences the performance of the duties of the judges in the lower courts as it provides official interpretation of how in particular the Civil and Commercial Code, which derived from Dutch law, is to be applied.

140 Based in Jakarta, see Staatsblaad No. 707/1915. Amendment were made in Staatsblaad No. 29/1927, Law No. 5 of 1959, in Law No. 17 of 1997, including changes in the court's official name.

Box 4 Independence of the Indonesian Tax Court – calls for reform

Since Suharto's authoritarian regime was ended in 1998, all aspects of Indonesian government, including the judicial system, have undergone reform. In 2000, the Indonesian Government put the Tax Court under the control of the Supreme Court, thereby giving it judiciary powers. The position of the Tax Court in the Indonesian judicial system however is 'outside' the four areas recognised by Article 24 of the Constitution as falling under the judicial powers of the Supreme Court (the public court, religious court, military court, and state administration court).

Following a number of corruption cases, including at the Directorate General of Taxes, the Indonesian Transparency Society (Masyarakat Transparansi Indonesia, MTI) conducted research¹⁴¹ into the Tax Court and proposed a number of reforms to address problems relating to regulatory, organisational, and human resources. At the regulatory level, the Indian Transparency Society found inconsistencies, multiple interpretations and regulatory overlaps. At the organisational level, Article 4 of Tax Court Law 14 from 2002 lays down that judicial technical guidance for the Tax Court is conducted by the Supreme Court, but places organisational, administrative and supervision of the Court's finances under the Ministry of Finance. As a result, the Indian Transparency Society found the independence of judges questionable as they are compromised to fairly decide in tax disputes, a point that has been reiterated since. For instance, most of the judges are ex-officials of the General Directorate of Taxation, encouraging collusion between judges and their former colleagues. Furthermore, the Ministry of Finance appoints and can dismiss Tax Court judges, which could influence their verdicts – favourable or unfavourable – regarding the revenue authority, depending on the links that might exist between political elites and large corporations. There have also been a number of high profile cases in Indonesia in which taxpayers succeeded in evading tax through the court by bribing tax officials and judges.¹⁴²

Another problem raised by commentators is the lack of technical capacity and small number of judges, in addition to the non-transparent judicial recruitment system.

Finally, Karyadi & Darussalam (2017:1245) note: *"The transparency in publicising its decisions has also been criticised as a factor contributing to its lack of independence. Although Indonesia introduced the Information Transparency Act in 2008, in practice, Tax Court case decisions are publicised on a selective basis depending on their level of sensitivity to the effect of public opinion. Consequently, inconsistencies in Tax Court decisions are rarely under public scrutiny."*

A new Tax Court law is currently being drafted, and Indonesian civil society organisations are developing a joint position paper to improve transparency, quality and governance.

141 MTI, Peta Masalah Pengadilan Pajak [A Mapping of Tax Court Problems] (2010). <https://www.scribd.com/document/87001839/Peta-Masalah-Pengadilan-Pajak>

142 See Budi Ispriyarso (2015) 'Weaknesses of tax court in Indonesia from the aspects of legal certainty and justice', in International Journal of Business, Economics and Law, Vol. 6, Issue 4 (Apr.), available via http://ijbel.com/wp-content/uploads/2015/05/Law52_PAID_IJBEL_weaknesses-of-Tax-Court-Budi-Ispriyarsoyurnal.pdf

The law states that cases that were filed at the Tax Dispute Settlement Board before 2002 but have not yet been heard and decided upon will be transferred to the Tax Court. Should a taxpayer not be satisfied with the outcome of their case, they can appeal with the Supreme Court.

According to statistics published by the secretariat of the Tax Court, some 10,000 tax disputes are lodged every year, of which some 13 per cent are partially granted and 43 per cent fully granted (see Table 3, Table 4 and Table 5).

Karyadi & Darussalam¹⁴³ note that, because of the large number of disputes, many of which have been rejected by the DGT, the Tax Court is handling a significant backlog of cases:

“The DGT itself is pressured by the ‘targeting system’ of the government. The ‘targeting system’ requires the DGT to collect a certain amount of tax revenue as determined by the government. Failure to do so may directly impact the DGT tax officials’ key performance indicator.”

Such a targeting system might of course also influence the quality and fairness of the decisions, given that large taxpayers might be able to influence outcomes and the questionable independence of the tax court.

Karyadi & Darussalam also posit that the dispute system in Indonesia “is relatively more opaque than in other G20 countries”.¹⁴⁴ In relation to the few cases that are litigated, judgments are rarely publicised and those that are published usually contain no reasoning beyond statement of facts and conclusions. Although judges often apply a formalistic approach, judgments are ostensibly incoherent.”

Table 3 Number of tax disputes filed 2012 - 2018

Filed at:	2012	2013	2014	2015	2016	2017	2018	All years
Director General of Taxes	5,114	5,217	7,386	7,669	7,109	5,553	7,813	45,871
Director General of Customs and Excise	1,754	2,749	3,017	4,069	3,024	3,994	3,574	22,181
Local Government	485	433	466	891	21	32	49	2,377
Total	7,353	8,399	10,869	12,629	10,154	9,579	11,436	70,359

Source: <http://www.setpp.depkeu.go.id/statistik>

143 Karyadi, Freddy & Darussalam (2017) Tax Treaty Disputes in Indonesia, in E. Baistrocchi (Ed.), A Global Analysis of Tax Treaty Disputes (Cambridge Tax Law Series, pp. 1234-1282). Cambridge: Cambridge University Press: p. 1255.

144 Karyadi, Freddy & Darussalam (2017) Tax Treaty Disputes in Indonesia, in E. Baistrocchi (Ed.), A Global Analysis of Tax Treaty Disputes (Cambridge Tax Law Series, pp. 1234-1282). Cambridge: Cambridge University Press: p. 1234.

Table 4 Tax Dispute Settlements in Indonesian Tax Court 2012-2018

	2012	2013	2014	2015	2016	2017	2018	All years
Revoked	75	81	95	174	1,350	1,524	250	3,549
Not eligible	1,037	1,013	859	1,187	1,782	701	1,053	7,632
Rejected	1,700	1,929	2,454	2,294	2,900	2,600	1,997	15,874
Additional taxes imposed	3	2	1	13	8	1	9	37
Partially granted	732	1,003	1,440	1,217	1,353	1,373	1,389	8,507
Fully granted	2,530	3,276	4,014	4,049	5,332	4,982	5,228	29,501
Cancelled	476	73	37	94	128	50	37	895
Total	6,553	7,377	8,900	9,028	12,853	11,231	9,963	65,905

Source: <http://www.setpp.depkeu.go.id/statistik>

Table 5 Percentage dispute outcomes of total 2012 - 2018

	2012	2013	2014	2015	2016	2017	2018	All years
Revoked	1%	1%	1%	2%	11%	14%	3%	5%
Not eligible	16%	14%	10%	13%	14%	6%	11%	12%
Rejected	26%	26%	28%	25%	22%	23%	20%	24%
Additional taxes imposed	0%	0%	0%	0%	0%	0%	0%	0%
Partially granted	11%	14%	16%	13%	10%	12%	14%	13%
Fully granted	39%	44%	45%	45%	42%	44%	52%	44%
Cancelled	7%	1%	0%	1%	1%	0%	0%	1%

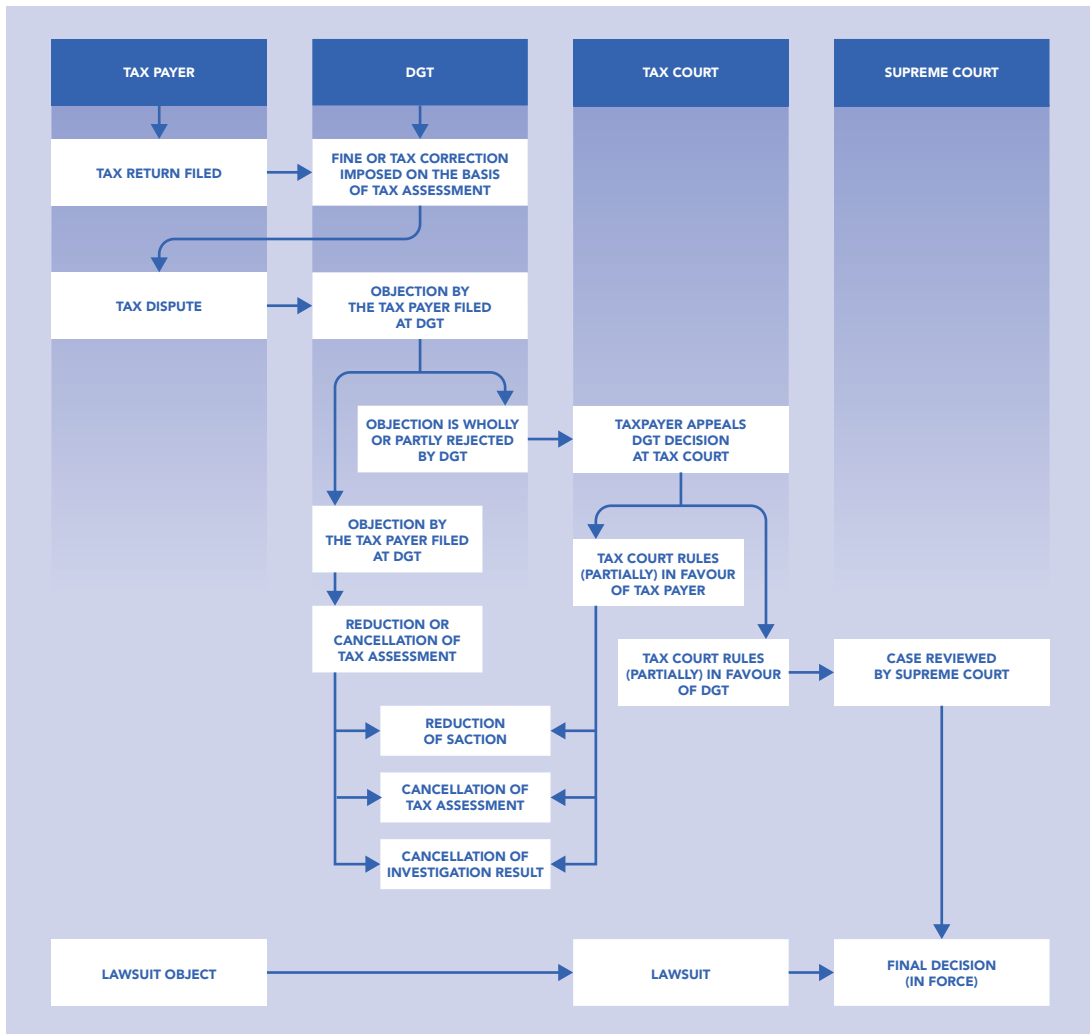
Source: own calculations

Decisions made by the Tax Court are generally final and binding, but certain procedural issues may allow grounds for appeal at the Supreme Court. Judicial review can be sought within three months, if one of the following criteria is met:

- ❑ If the decision is considered to be based on an act of perjury or deception on the part of one of the parties or based on evidence that is subsequently found to be invalid by a criminal court judge.
- ❑ If there is new, very important written evidence that could alter a decision if it had been discovered in an appeal or if it had been discovered in the original case.
- ❑ If a decision clearly does not conform with prevailing tax regulations.¹⁴⁵

145 PWC (2017) Indonesian Pocket Tax Book, p. 103, available via <https://www.pwc.com/id/en/pocket-tax-book/english/ptb-2017.pdf>

Figure 7 Tax dispute decision-making tree



Source: authors

Another legal aspect relevant when analysing Tax Court decisions is the hierarchy of legislation in Indonesia between Indonesian domestic law and international laws, and the position of tax legislation in Indonesia’s legal system.¹⁴⁶

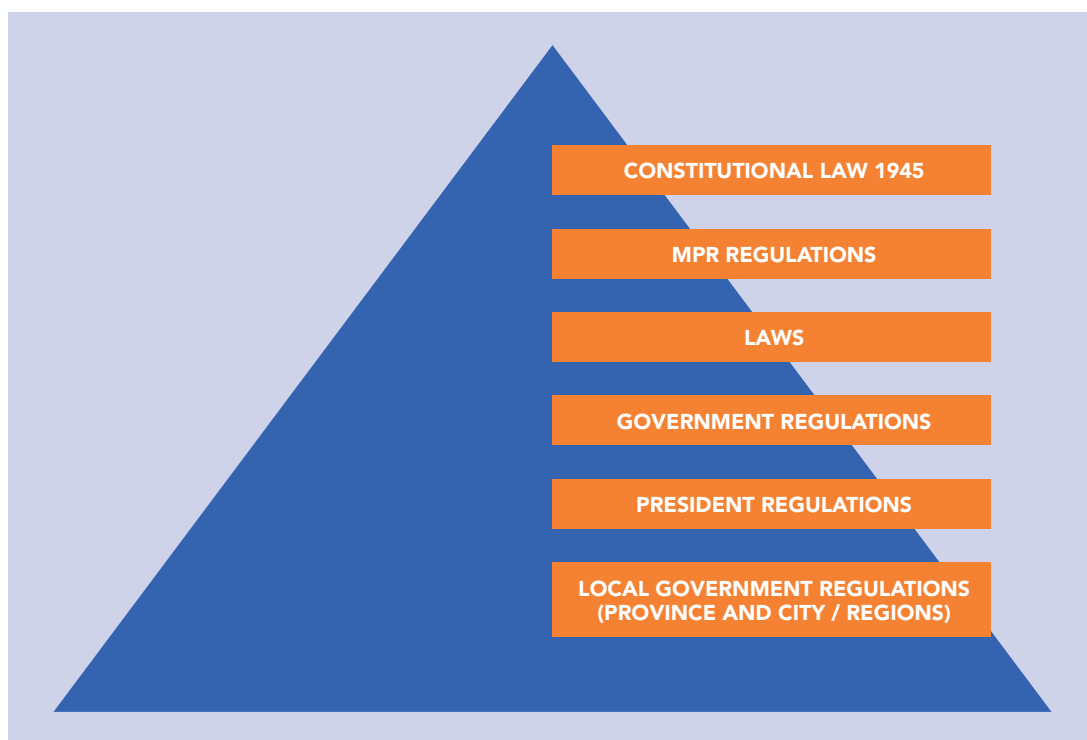
Indonesia’s civil law system uses statute or legislation as the main source of law.¹⁴⁷ In civil law, unlike common law, the courts are not bound by precedents, and court decisions are made by a panel

146 See Article 7 paragraph (1) Law No. 12 of 2011 on Formation of Regulation and Legislation.

147 Lev, D. S. (1965). The lady and the banyan tree: civil-law change in Indonesia. *The American Journal of Comparative Law*, 282-307.

of judges. In relation to international law, Indonesia applies dualism as well as monism. In the former system, international laws, such as treaties and other customary laws, are not automatically transposed into domestic law.¹⁴⁸ To become domestic law, international treaties are ratified by the Indonesian Government and Parliament but treaties relating to business and economic matters, including tax treaties, are ratified by the President.¹⁴⁹ Karyadi & Darussalam, in their recent analysis of tax disputes in Indonesia, note that “there is [...] no provision in the Constitution that governs the relationship between international and domestic laws, and no law or doctrine exists on the implementation of treaties in the Indonesian domestic legal system. [...] Indonesia’s practice on the implementation of treaties has not been consistent. There are several examples of non-tax treaties implemented in domestic laws. Nevertheless, tax treaties are never implemented in domestic laws, but enter into force once they are approved and ratified by presidential decree. Thus, it can be concluded that, with regard to tax treaties, Indonesia practices monism.¹⁵⁰” Tax treaties, nonetheless, by definition prevail over domestic law.

Figure 8 Hierarchy of laws in Indonesia



Source: *Perkumpulan Prakarsa*

148 Butt, S. (2014). The position of international law within the Indonesian legal system. *Emory Int'l L. Rev.*, 28, 1.

149 See Article 10 and 11 paragraph (1) Law No. 24 of 2000 on International Treaty.

150 Karyadi, F., & Darussalam. (n.d.). Tax Treaty Disputes in Indonesia. In E. Baistrocchi (Ed.), *A Global Analysis of Tax Treaty Disputes* (Cambridge Tax Law Series, pp. 1234-1282). Cambridge: Cambridge University Press: p. 1249.

The 1945 Constitution is at the top of the pyramid as it forms the basis for all laws and regulations.¹⁵¹ Legislation below cannot exceed or contradict the higher legislation. All laws, therefore, including the Tax Treaty, should harmonise with the Constitution. Any contradictions will potentially be reviewed by the Constitutional Court and the Supreme Court.

In the tax law hierarchy, tax treaties prevail over domestic tax laws or regulations (*lex superior derogat legi inferiori*) and DTAs have the status of a special law which overrides general tax law (*lex specialis derogat legi generali*)¹⁵²; if there is tension between a DTA and domestic tax law on the same matter, the DTA should prevail. If domestic law is applied, in contradiction to a treaty law definition (with regard to beneficial ownership, for instance), this would constitute a so-called treaty override, which can be challenged by the other contracting state and the taxpayer. In addition, although Indonesia has not signed the Vienna Convention on the Law of Treaties (VCLT), it considers the VCLT as part of customary international law and therefore considers itself bound by its provisions, which codifies basic principles of international law.¹⁵³

In interpreting tax treaties, the authorities also have to consider several domestic laws, such as Article 1338 of the Indonesian Civil Code and the Law on Income Tax.

5.2.1 Application of the treaty in practice

The DGT has issued a number of Regulations (Peraturan, Per) and Circular Letters (Surat Edaran, SE) to clarify the application of treaty law to taxpayers. These are subject to debate in the tax disputes discussed in the following section. Whilst Circular Letters are lower in hierarchy to laws and regulations, they follow criteria and guidelines used in the OECD Commentaries on the Articles of the Model Tax Convention.

Mode of application

The tax dispute cases relevant to the Indonesia-Netherlands DTA often concern the application of the interest income exemption under Article 11(4) DTA.¹⁵⁴ Article 11(5) stipulates that both states will, by mutual agreement, settle the mode of application of Article 11(3 and 4), the zero withholding tax rate provision, of the 2002 DTA as well as the reduced WHT interest rate of 10 per cent under Article 11(2).

151 On taxation, the constitutional basis of taxation was ruled by Article 23A the 1945 Constitution that states: "All taxes and other levies for the needs of the state of a compulsory nature shall be regulated by law" (Government of Indonesia, 1945).

152 The *lex specialis* principle lays down that specialised laws prevail over general laws. A specific treaty governing principles of international taxation thus overrides a domestic law on general tax matters (*lex generalis*).

153 Karyadi, Freddy & Darussalam (2017:1251). Articles 31, 32 and 33 VCLT stipulate that the 'treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose'. In addition, both parties shall also consider Commentaries OECD Model on double treaty agreement as a G20 member. Article 27 stipulates each State Party must divide the taxing rights in a balanced manner and in good faith.

154 Which at the time applied 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.

The DGT issued a Circular Letter on 1 June 2005 (No. SE-17/PJ/2005), which effectively annulled the exemption from Indonesian WHT interest under Article 11(4) arguing that, unlike Article 11(5) stipulated, the competent authority of Indonesia, and the competent authorities of the Netherlands “have not had any discussion regarding the implementation provisions”. The Circular stipulates that the exemption therefore cannot be applied until Indonesia and the Netherlands agree upon implementation provisions. In the meantime, the Circular states that the reduced Indonesian WHT interest rate of 10 per cent, available under Art. 11(2) of the DTA, should be applied.

This unilateral measure, which was later declared to be in violation of the spirit of the tax treaty by the Indonesian Tax Court, was taken because of the proliferation of treaty shopping when the exemption came into force under the 2002 DTA. The move was met with discontent and surprise by some tax practitioners and legal commentators (“It is somewhat surprising that Indonesia and the Netherlands have misunderstood each other in this way with respect to the interpretation of the exemption”),¹⁵⁵ and ultimately led to negotiations between the two countries resulting in the 2015 Protocol (in force only since October 2017). This abolished the WHT exemption on interest income and abolished the mutual agreement on the mode of application of Articles 10, 11 and 12, as requirement for the application of these Articles (see above).

Beneficial ownership

Another important criterion laid down for the granting of reduced WHT rates in treaties on passive income such as interests, dividends, and royalties is that the recipient of this income must be the beneficial owner. Indonesia and the Netherlands do not have a detailed mode of application regarding Article 11(4) DTA (on interest), and also do not have a common definition of a beneficial owner. The DGT therefore defined the term ‘beneficial ownership’ in Circular Letter No. SE-04/PJ/2005, amended by Circular Letter No. SE-03/PJ/2008 and PER-62/PJ/2009. These letters have since been repealed¹⁵⁶.

Certificate of Domicile

As mentioned in Chapter 3, in order to enjoy treaty benefits a foreign recipient of income generated in Indonesia must also provide a Certificate of Domicile (COD) approved by Indonesia and certified by their home country tax authority which states that the recipient is a tax resident of that country (Government Regulation No. 94/2010). Without a certified COD, or if the Indonesian Revenue Authority finds the recipient of the passive income abroad is not the beneficial owner of that income, a WHT rate of 20 per cent will apply. The COD does not automatically mean lower WHT rates are applied to outgoing payments, as additional criteria, such as beneficial ownership, may also be required. A COD needs to be reviewed once a year (No. SE-03/PJ.101/1996 (Point 3.c)).

155 Drijer, Hans & Houben, Wendy (2005) INDONESIA – Application of Interest Withholding Tax Exemption under Tax Treaty with the Netherlands Postponed, *Asia-Pacific Tax Bulletin*, September/October 2005, IBFD: p. 432.

156 Karyadi, Freddy & Darussalam (2017) *Tax Treaty Disputes in Indonesia*, in E. Baistrocchi (Ed.), *A Global Analysis of Tax Treaty Disputes* (Cambridge Tax Law Series, pp. 1234-1282). Cambridge: Cambridge University Press.

With regard to the details required for a COD, the DGT issued Regulation No. 61/2009 which stipulated in Article 5 that the COD “is used as the basis for implementing the regulations as stipulated in the Tax Treaty, starting on the date on which the COD was certified by the tax authority of the Tax Treaty partner countries and remains in effect for 12 months.” This was amended by Regulation No. 24/2010, and currently two standard COD forms exist for non-resident taxpayers: Form DGT 1 for non-banks and Form DGT 2 for banks and custodians. The “content of these standard forms as issued by the DGT has gone beyond the residence requirements [...] of the OECD Model and also contains several other confirmations that the income recipient must fill in.”¹⁵⁷

157 Karyadi, Freddy & Darussalam (2017) *Tax Treaty Disputes in Indonesia*, in E. Baistrocchi (Ed.), *A Global Analysis of Tax Treaty Disputes* (Cambridge Tax Law Series, pp. 1234-1282). Cambridge: Cambridge University Press: p. 1250.

6 Analysis of 27 court decisions in Indonesia on corporate abuse of the treaty

This chapter discusses the disputes between taxpayers and the Indonesian Tax Authority based on 27 Tax and Supreme Court case decisions. The cases included in this report occurred between 2003 and 2015, when the DTA 2002 was applicable. The discussion exposes a number of problems in the application of the treaty and Indonesian Tax Law that allows Dutch conduit entities to continue being used by foreign and Indonesian companies to avoid taxation in Indonesia. The barriers identified to the tax authorities successfully challenging undue granting of treaty benefits to tax payers do not only concern treaty shopping but generally raise questions as to the allocation of taxing rights between Indonesia as a net capital receiving and the Netherlands as net capital exporting state.

Table 6 List of tax dispute decisions and their outcomes (2010-2015)

2010					
1	PT. Azko Nobel Car Refinishes Indonesia Akzo Nobel Coating International BV Belanda	407/B/PK/PJK/2010	COD	DGT lost at Supreme Court	559,768,373
2011					
2	PT. Boskalis International Indonesia Marsh BV Belanda	155/B/PK/PJK/2011	COD	DGT lost at Tax Court and Supreme Court	7,286,296,144
3	PT. Tapian Nadenggan Indonesia Goederhand Finance BV, Belanda	770/B/PK/PJK/2011	COD	DGT lost at Tax Court and Supreme Court	166,384,744
2012					
4	PT. Tapian Nadenggan Indonesia Goederhand Finance BV, Belanda	860/B/PK/PJK/2012	COD	DGT lost at Tax Court and Supreme Court	727,200,474
5	PT. Bredero Shaw Bredero Price Holding BV, Belanda	230/B/PK/PJK/2012	Royalty	DGT won at Tax Court and Supreme Court	-
2013					

No	Company	Case No	Legal issues	Decision	Potential Loss Income (IDR)
6	PT. Ekamas Fortuna Dupoer Finance BV, Belanda	274/B/PK/PJK/2013	Beneficial Owner	DGT lost at Tax Court and Supreme Court	194,456,782
7	PT. Indosat, Tbk Indosat Finance Company BV, Belanda	696/B/PK/PJK/2013	Beneficial Owner	DGT lost at Tax Court and Supreme Court	13,779,405,184
8	PT. Indosat, Tbk Indosat Finance Company BV, Belanda	736/B/PK/PJK/2013	Beneficial owner	DGT lost at Tax Court and Supreme Court	14,185,647,609
9	unknown	PUT.43780/PP/M.XII/13/2013	Interest	DGT lost at Tax Court	17,801,389,116
10	Friesland Brands BV, Belanda	42729/PP/M.II/15/2013	Royalty and Transfer pricing	DGT lost at Tax Court	188,347,346,594
11	Schlumberger Finance BV, Belanda	55897/PP/M.IA/13/2014	Beneficial Owner Interest	DGT lost at Tax Court	47,858,344,723
12	AGB Nielsen Media Research Netherlands	48393/PP/M.X/13/2013	COD and Business Profit	DGT lost at Tax Court	423,802,455
13	Bekaert Holding BV, Belanda	43407/PP/M.VI/13/2013	Interest Dividends	DGT lost at Tax Court for Interest, but DGT won for dividends	10,594,892,882
14	Goederhand Finance BV, Belanda	43981/PP/M.II/13/2013	COD	DGT lost at Tax Court	1,569,898,415
15	Goederhand Finance BV, Belanda	43893/PP/M.II/13/2013	COD	DGT lost at Tax Court	593,963,364
16	PT. Ekamas Fortuna Dupoer Finance BV, Belanda	281/B/PK/PJK/2013	Beneficial Owner	DGT lost at Tax Court and Supreme Court	181,616,812
17	PT. Omnes Services Indonesia Schulmberger Finance BV, Belanda	324/B/PK/PJK/2013	COD	DGT lost at Tax Court and Supreme Court	1,077,262,139
18	Markserv BV, Belanda Sol Maninvest BV, Belanda	44916/PP/M.V/99/2013	COD	DGT lost at Tax Court	7,663,429,721
19	Markserv BV, Belanda Sol Maninvest BV, Belanda	44915/PP/M.V/99/2013	COD	DGT lost at Tax Court	6,693,382,940
20	Pindo Deli Finance BV, Belanda Boondaal Finance BV, Belanda, Welsington BV	45925/PP/M.XIII/13/2013	Dividend Beneficial Owner	DGT lost at Tax Court	40,260,806,262
2014					
21	Schlumberger Finance BV, Belanda	55897/PP/M.1A/13/2014	COD	DGT lost at Tax Court and Supreme Court	14,500,614,399
22	PT. Wirakarya Sakti Dupoer Finance BV, Belanda	647/B/PK/PJK/2014	Beneficial Owner	DGT lost at Tax Court and Supreme Court	5,644,533,200
2015					
23	PT. Wirakarya Sakti Dupoer Finance BV, Belanda	306/B/PK/PJK/2015	Beneficial Owner	DGT lost at Tax Court and Supreme Court	5,281,051,040
24	PT Ecco Tannery Indonesia ECCO Leather BV, Belanda	937/B/PK/PJK/2015	Dividend	DGT won at Tax Court but lost at Supreme Court	314,138,666
25	PT Ecco Tannery Indonesia ECCO Leather BV, Belanda	967/B/PK/PJK/2015	Dividend	DGT won at Tax Court but lost at Supreme Court	288,870,666
26	PT. Ecco Tannery Indonesia	940/B/PK/PJK/2015	Dividend	DGT won at Tax Court but lost at Supreme Court	293,081,999
27	PT Ecco Tannery Indonesia ECCO Leather BV, Belanda	1022/B/PK/PJK/2015	Dividend	DGT won at Tax Court but lost at Supreme Court	297,293,332

6.1 Main issues raised and relevant treaty articles in selected tax disputes

Legal analysis of the 27 decisions raised a number of issues. Firstly, disputes revolve around the question whether a COD, issued by the Dutch tax authorities, is sufficient proof that a company is a tax resident of the Netherlands and therefore eligible for treaty benefits, or whether additional proof of beneficial ownership (the received dividend, interest or royalty, for example) is required for the company to enjoy treaty benefits. The question therefore arises whether the Circular Letters from the DGT on the application of Article 11(4) DTA (on interest) and the COD provide sufficient legal basis for DGT's denial of treaty benefits.

Regarding beneficial ownership, the Indonesian Tax Authority uses its own criteria laid down in Circular Letters (2005, 2008 and 2009) to determine beneficial ownership of income received under Article 10(2), Article 11(2,4), and Article 12(2) DTA, though the legal basis of this is challenged in the disputes.

Secondly, there are different interpretations of the classification of income and transfer pricing disputes, leading to different tax treatments of that income. For instance, a 'trading commission' and 'interest loan payment' were re-classified by DGT as dividend, and 'home office expenses' and 'marketing, promotional and management fee' were re-classified by DGT as royalty income. Thirdly, there is dispute over whether a business constitutes a PE (Article 5), because business profits (Article 7) can only be taxed by the source state if they can be attributed to a PE, the criteria for which are laid down in the treaty.

The legal issues discussed below specifically relate to the following Articles in the Indonesia-Netherlands DTA 2002 and their interpretation:

1. Fiscal Domicile and Certificate of Domicile (COD) (Article 4)
2. Beneficial Ownership (Articles 10, 11 and 12)
3. Dividends (Article 10)
4. Interest (Article 11)
5. Royalties (Article 12)
6. Taxing business profits (Article 7) of a permanent establishment (Article 5)

6.1.1 Incorrect use of Certificate of Domicile (tax residency) granted by the Dutch authorities

One typical dispute arising in the application of the Indonesia-Netherlands DTA is whether the COD, which is issued by the Dutch authority and declares a legal entity to be a tax resident (termed 'fiscal domicile' in the treaty), will directly result in the company enjoying treaty benefits.¹⁵⁸ As mentioned above, according to Articles 10, 11 and 12 of the DTA, treaty benefits are only granted if the recipient of dividends, interest, or royalties qualifies as a 'beneficial owner' of that income. The Indonesian Tax Authority requires foreign taxpayers (Dutch related companies) to show additional evidence of beneficial ownership of the received income, arguing that a COD alone is not sufficient proof.

158 Cases 1 (Akzo Nobel/2010), 2 (Boskalis/2011), 3 (Tapien Nadenggan/2011) and 4 (Tapien Nadenggan/2012).

In some cases, the DGT also underlined that, according to Circulars,¹⁵⁹ the COD should be renewed every year. CODs issued more than one year before the tax year under dispute were thus not valid, and the COD could not be applied retroactively. The Court, however, ruled in favour of a company even when the COD was issued two years after the dispute year in question: in Case 2 (PT Boskalis International Indonesia/2011) the COD was issued on 24 August 2007, two years after the tax year of the dispute (2005). The company successfully argued that a lack of a valid COD did not prove that Marsh BV, as insurance agent and broker for Boskalis, was *not* fiscally domiciled in the Netherlands. As a result, Marsh BV was still eligible to receive the exemption from WHT on interest as stipulated in the 2002 DTA.

The judges at the Tax Court argued that Circular Letter No. SE-O3/Pj.101/1996 laid down that a COD triggers the application of treaty law. The Supreme Court adopted the consideration of the Tax Court and also decided in favour of the company, granting it treaty benefits. The Supreme Court also (incorrectly) ruled that the fiscal domicile qualified the company as the beneficial owner. It thus annulled the DGT's tax payment correction, arguing it would constitute a violation of Article 11(4) of the Indonesia-Netherlands DTA.

In an interview conducted for this report, a Supreme Court Judge argued that, for Indonesian judges, the COD was sufficient evidence to determine fiscal domicile. As long as a foreign taxpayer and company had a COD, the Judge was of the opinion that the taxpayer was tax eligible in the country that issued the COD. On the year of issuance in the Boskalis case mentioned above, the Judge held that although a COD cannot be issued retroactively, because the Dutch COD from 2007 did not mention a specific tax year period, the company could reasonably claim that it had also been tax resident in the Netherlands in 2005.

6.1.2 Problems with beneficial ownership (article 11 DTA)

“Beneficial ownership is a unique treaty concept in the sense that it is used almost exclusively in treaties based on the OECD Model, and has no clear meaning under the domestic tax law of most countries. It originated in the United Kingdom and was used to distinguish from legal ownership in circumstances where the legal ownership was akin to a nominee or agent. Since its adoption into the Model in 1977¹⁶⁰, beneficial owner has been incorporated into the UN Model Convention and the vast majority of bilateral tax treaties.”

Jinyan Li, 2012¹⁶¹

159 Specifically the guidance given in Point 3 (c) of Circular Letter No. SE-03/PJ.101/1996.

160 OECD (1977) Model Double Taxation Convention on Income and on Capital: Report of the OECD Committee on Fiscal Affairs.

161 Li, Jinyan (2012) 'Beneficial Ownership in Tax Treaties: Judicial Interpretation and the Case for Clarity'. Osgoode Hall Law School: Comparative Research in Law and Political Economy, 4, p. 187-209 <http://digitalcommons.osgoode.yorku.ca/cgi/viewcontent.cgi?article=1004&context=clpe>, p. 189.

Beneficial ownership, already mentioned in Chapter 3, limits when a company can take advantage of a tax treaty's reduced tax rates. Article 11(4) DTA, for instance, lays down that "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" [emphases added].

Unsurprisingly then, beneficial ownership status is contested in many of the cases discussed in this report,¹⁶² and is indeed the subject of legal challenges in many OECD countries, having led to a revision of the OECD commentaries in 2013.¹⁶³

As described in the previous sub-chapter (5.2.1), because the term is not clearly defined by the DTA, the Tax and Supreme Court judges argue that its interpretation and implementation requires a mode of application to be established by both Indonesia and the Netherlands. This is however, a questionable interpretation, as the mutual agreement on the mode of application is not a necessary prerequisite for the application of treaty benefits.

According to the negotiated 2015 Protocol, which came into effect on 1 October 2017, a mutual agreement on the mode of application of the dividend, interest and royalty articles of the tax treaty, is no longer included in the DTA. Furthermore, the amending protocol (art. 6) states 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*".

Given the lack of a mode of application defining beneficial ownership in the period before the application of the 2015 protocol, the DGT released and used the DGT Circular Letters No. SE-04/PJ.34/2005, No: SE-03/PJ.03/2008 and NO: PER-62/PJ/2009 as guidelines to determine criteria for beneficial ownership status (these have since been revoked). According to the Circular Letters, in reference to the domestic Income Tax Law, the DGT specifies that the beneficial owner has to be the actual owner of dividend, interest and royalty income and, importantly, that entities categorised as SPEs (conduit companies, letterbox companies, pass-through entities and so forth), do not qualify as beneficial owners.

In Case 6 (Ekamas Fortuna Indonesia and Dupoer Finance BV), DGT provided evidence that Dupoer was a conduit company and thus denied it beneficial ownership status. The same condition was also applied in Cases 7 and 8 (both Indosat Finance Company BV). In their appeal to the Supreme Court, DGT also cited Tax Court decisions in Case 23 and another decision from 2010 (No. 23289/PP/M. II/13/2010),¹⁶⁴ which both ruled that Indosat Finance Company BV did not qualify as a beneficial owner of the received interest income.

¹⁶² Cases 3, 4, 6, 7, 8, 10, 11, 13, 15, 16, 17, 22, 23.

¹⁶³ See 'Beneficial Ownership: An Introduction' (November 2012), in Canadian Tax Focus, Volume 2, Number 4, Canadian Tax Foundation. For an in-depth discussion, see Michael Lang & Pasquale Pistone et al (eds), 2013, Beneficial Ownership: Recent Trends, Amsterdam: IBFD.

¹⁶⁴ Referred to by the DGT in Case 8.

In Cases 7 and 8 (Indosat Tbk) and 20 (Pindo Deli Finance BV, Welsington BV), the companies argued that the DGT was inconsistent in applying the DTA. Welsington BV argued that the WHT rate in Article 11(2) DTA had been applied by the DGT until the appeal of the DGT to the Supreme Court. In its initial argument for the tax correction, DGT said Welsington BV was not tax resident in the Netherlands. Only when the case came to the Supreme Court did the DGT also argue it was not the beneficial owner of the received income. Until the appeal, DGT thus never denied that Welsington BV and other recipients (Asia Special Situation GIDRI BV and Getus BV) were the beneficial owners of the income. Despite the judges having the freedom to consider new evidence and different legal arguments, they agreed with the reasoning of the companies.

In the two cases involving Indosat Tbk and Indosat Finance Company BV (7 and 8), the company argued that Indosat Finance Company BV fulfilled the criteria of beneficial owner as authorised by the Dutch tax authority in its ruling practice, based on a Dutch Circular Letter (Decree) of the State Secretary for Finance. These substance requirements have however never been formulated by the Dutch authorities as requirements for beneficial ownership status. Rather than defining beneficial ownership, the Decree describes conditions (namely, substance requirements, see also Chapter 4.2.1) to determine whether the tax authorities of the Netherlands will not provide rulings to companies used for international financing and holding structures for groups of companies.¹⁶⁵

Examining the dispute, the Tax Court considered the OECD Commentary to OECD Model Tax Convention, the OECD Tax Glossary and the International Bureau for Fiscal Documentation (IBFD) International Tax Glossary for guidance on the determination of beneficial owner for the application of Article 11. In line with the decisions on tax residency discussed above, the Tax Court and later the Supreme Court rejected the DGT argument and regarded the Dutch tax authorities' granting of eligibility of the company as a tax resident as sufficient to determine beneficial ownership, thereby qualifying for relief from WHT interest under Article 11 of the DTA. This is however questionable, as fiscal domiciliation does not imply that the taxpayer is the beneficial owner. This furthermore demonstrates that the Indonesian judges' definition and application of criteria for beneficial ownership and tax residency is up for discussion.

The Indonesian court decisions need to be regarded in the context of common practices by other jurisdictions regarding beneficial ownership determination tests,¹⁶⁶ where economic rather than formal legal criteria is used. That is, the beneficial owner must be the entity that economically benefits from the assets in question. However, the letterbox companies that are officially administered by trust offices can still qualify, under certain circumstances, as the beneficial owner.

165 IFZ 2004/126 of 11 August 2004. This Circular Letter describes the conditions under which the Dutch tax authorities will or will not issue rulings on Dutch interposed companies engaged in intermediary financing activities for groups of companies, namely substance requirements and exposure to risk. The substance criteria require the entity to have qualified directors and personnel. Risk is assumed if the company's equity is equal to a minimum of 1% of the amount of outstanding loans or EUR 2 million per loan (whichever is lowest). This Circular was updated by in 2014 (DGB 2014/3101), published at <https://zoek.officielebekendmakingen.nl/stcrt-2014-15957.html>

166 See *Indofoods* (Court of Appeal England, 2006), *Prevost* (Tax Court Canada, 2008), *Danish Case* (Danish National Tax Tribunal, 2012), and OECD Draft Clarification of Beneficial Owner.

This is confirmed by the OECD definition in relation to beneficial owners of dividends, which states that *'The recipient of a dividend is the "beneficial owner" of that dividend where he has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the full right to use and enjoy the dividend; also, the use and enjoyment of a dividend must be distinguished from the legal ownership, as well as the use and enjoyment, of the shares on which the dividend is paid.'*¹⁶⁷

Box 5 Anti-abuse rules in national legislations

Corporate law, in most countries, has very weak economic substance requirements or none at all. These requirements might include a minimum number of salaried employees, adequate capital requirements that reflect the size of the company or turnover or sales. However, other policy areas apply rules on whether a legal entity may enjoy certain legal benefits that come with incorporation in a given jurisdiction. In fact, substance is a much-debated topic in tax law, because of the far-reaching consequences incorporation has for corporate tax planning and related public revenues.

Many tax laws include anti-tax planning rules intended to protect the policy goals of the statutory regime. "These rules range from specific prohibitions that make certain types of planning strategies ineffective to broad "anti-abuse" rules intended to reach strategies that lawmakers cannot yet envision."¹⁶⁸ For instance, so-called look-through-rules enable tax authorities to disallow certain transactions of letterbox companies to target the beneficial owner of the company and ignore corporate vehicles that are intercepted for the purpose of avoiding tax. Tax rules might also check the economic reality and business purpose of a transaction by requiring a partner in a venture to actively participate in the venture, or limit the amount of money that is deductible for tax reasons. General anti-abuse rules "are designed to curb regulatory arbitrage without any particular transaction or strategy in mind". When a transaction is deemed an avoidance transaction by the revenue authorities or a judge, the tax consequences will be re-determined to deny the tax benefit that would have otherwise resulted from the transaction.

167 OECD (2011) Clarification of the Meaning of "Beneficial Owner" in the OECD Model Tax Convention. Discussion Draft, p. 4.
URL: <http://www.oecd.org/tax/treaties/47643872.pdf>

168 Fleischer, Victor (March 2010). Regulatory Arbitrage, University of Colorado Law Legal Studies Research Paper No. 10-11, University of San Diego School of Law, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1567212, p. 28.

Box 5 Anti-abuse rules in national legislations

This means that in some jurisdictions, tax law lays down general or specific anti-abuse rules that, interpreted by tax authorities or judges, result in customary law on substance. These judgements can strip legal entities of relevance, or entirely negate them in a transaction. Whether a country applies substance rules or not, depends on the legal doctrine it applies in tax law and practice, often referred to as form over substance or substance over form doctrines. When an artificial legal corporate structure is challenged by tax authorities on grounds of tax avoidance, “the taxpayer relies on the form and the government makes the argument, in one variation or another, that the transaction should not generate the tax benefits attendant to its form because that form does not reflect its substance or because the transaction has no substance-i.e., no business purpose.”¹⁶⁹

The legal cases in this regard are often complicated, because a legal corporate structure can have both elements: a real business purpose as well as a tax avoidance purpose. Case law thus uses examples of transactions that reflect both purposes. Relying on customary law also means interpretations of so-called substantiality doctrines differ widely between courts and jurisdictions as well as between tax law practitioners and judges, the former typically applying a form over substance approach. Indeed, using the legal form in a corporate structure to reduce or control the tax results of a given substantial transaction is a tax lawyer’s bread and butter: “To the tax shelter promoter and its adviser, form is always a friend and substance always an enemy to be expiated. In a tax shelter, form is malleable because it needs to conform only to tax needs and not business objectives.”¹⁷⁰

The OECD commentary also states that when the recipient entity has only very limited powers regarding the income and assets in question, it is acting as a mere fiduciary or administrator on behalf of the interested parties, and is, therefore, not the beneficial owner. In other words, when determining beneficial owner status, a primary consideration should be economic rather than legal substance. This requires that the evidence of the company’s economic activity (such as sufficient qualified staff on the payroll of the company rather than a company service provider) should be thoroughly assessed. The Tax Court did not endorse that approach.

169 Canellos, Peter (2001). Tax Practitioner’s Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters, <http://scholar.smu.edu/cgi/viewcontent.cgi?article=1831&context=smulr>, p. 49.

170 Ibid, p. 50.

6.1.3 National law vs. treaty law

One problem identified in this report is the questionable interpretation by the Indonesian judges on the application of the DTA. The Judge interviewed for this report is of the opinion that uncertainties in the interpretation of the DTA cannot be solved by unilateral measures such as Circular Letters that define the criteria for beneficial ownership, and that any regulations made without a MAP¹⁷¹ are to be considered a treaty override. As long as both parties – Indonesia and Netherlands – do not revise the DTA, it will remain the legal basis for appeal decisions.

The Tax Authority conversely argued that the implementation of Article 11(5) DTA resulted in differing interpretations, and, due to the absence of a mode of application of Article 11(5) DTA, it issued guidance in Circular Letter No. SE-17/PJ/2005 on how to determine which state can tax on the basis of beneficial ownership status and length of loan period. As explained above, this was a unilateral response to treaty abuse of the WHT exemption on outgoing interest rather than an introduction of an anti-abuse rule: the Circular stipulated that the exemption cannot be applied as long as Indonesia and the Netherlands have not agreed on an implementation provision. In the meantime, the Circular states, the reduced Indonesian interest WHT of 10 per cent, available under Article 11(2) of the DTA should be applied. The Indonesia unilateral action to deny the WHT exemption on outgoing interest was however not in accordance with the DTA and constituted a clear treaty override.

Responding to criticism that this domestic regulation constituted a treaty override, the DGT argued that such domestic guidelines were required because of the lack of a common mode of application, and so that Indonesia can still interpret ‘good faith’ in the DTA as stipulated in Article 31 of the Vienna Convention on the Law of Treaties.

In defence, the taxpayers rejected the binding nature of the Circular Letter and argued it breached Article 11(5), which requires the competent authorities of the two states to mutually agree on how to interpret and apply Article 11. In addition, the DTA is higher in hierarchy than the Circular Letter and Article 26 of Indonesia’s Income Tax Law. This was also the legal argument used in Case 6 (PT. Ekamas Fortuna Indonesia and Dupoer Finance BV).

The Court’s opinion was much shorter than the parties’ argument. It found that, based on the facts in these cases, the company (Dupoer Finance BV) was incorporated and fiscally domiciled in the Netherlands. The Supreme Court also rejected the DGT’s claim that the previous decision of the Tax Court contradicted Article 91(e) Law No. 14 of 2002, and ruled in favour of the companies.

171 The Mutual Agreement Procedure (MAP) is described as follows in the 2002 DTA between Indonesia and the Netherlands (art. 27): “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 this 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 or, if his case comes under paragraph 1 of Article 26, to that of the State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Agreement.”

URL: <https://zoek.officielebekendmakingen.nl/trb-2002-33.HTML>

In an opinion, the Court stressed that, when multiple interpretations are possible, a MAP must be established. Unless either state revises the DTA, the DTA remain the legal basis; unilateral regulation therefore would not be binding.

Considering this argument, alongside UN and OECD commentaries which provide room for domestic interpretation to avoid treaty abuse, it raises the question as to whether the court here has sufficiently addressed the general rule for interpretation of tax treaties as prescribed under Articles 31, 32 and 33 of the Vienna Convention. The court, for example, did not elaborate on the meaning of 'good faith', and its impact and application to the case. It also did not examine the 'object and purpose' of the DTA and other procedures to determine the specific meaning of terms used in the DTA if they are formulated in an ambiguous manner, and when the result of their implementation is manifestly absurd or unreasonable when considering the object and purpose of the treaty. Given that the cases concerned treaty benefits granted to Dutch conduit structures, the court's opinion was formalistic rather than substantive, and unless more substantive tests are introduced, there is a danger that, as with the 2015 Protocol, similar future disputes brought to the court will end in a positive ruling for the corporate taxpayer.

6.1.4 Disputes regarding dividends (Article 10 DTA)

Another issue identified in the analysed disputes relates to dividends (Article 10 DTA 2002). The main questions that arose were: (1) whether a 'trading commission' cost should be characterised as dividend,¹⁷² and (2) whether 'interest loan payment' should be characterised as dividend.¹⁷³

In the case of ECCO Leather BV and PT. ECCO Tannery Indonesia,¹⁷⁴ the Tax Authority argued that a trading commission and interest loan payment should qualify as dividend – or rather a hidden form of a dividend – because there were indications that the company breached the arm's length principle.¹⁷⁵ The DGT claimed that the company failed to prove that a cost for a trading commission was a fair transaction. In contrast, the company argued that the DGT had insufficient evidence to support their claim. In reference to Article 4 (1) of Indonesia Income Tax Law, PT. ECCO Tannery Indonesia argued that a payment for a commission could not constitute a 'dividend' as described under Article 10 (5) DTA, which defines a dividend as income from shares.

In the first instance, the Tax Court found the correction made by the DGT to the trading commission cost to be justified. The Court found that the commission cost paid by PT. ECCO Tannery Indonesia to ECCO Leather BV was not based on a cost for services delivered by ECCO Leather BV to PT. ECCO Tannery Indonesia, but on a percentage from buying raw materials and selling factory products.

172 Case 24.

173 Case 13.

174 Case 24.

175 The "arm's-length principle" of transfer pricing states that the amount charged by one related party to another for a given product must be the same as if the parties were not related. An *arm's-length price* for a transaction is therefore what the price of that transaction would be on the open market. Tax Justice Network (2013). Transfer Pricing. The Dar Es Salaam Transfer Pricing Seminar, Oct 2013. URL: <https://www.taxjustice.net/topics/corporate-tax/transfer-pricing/>

Following an appeal by the company, however, the Supreme Court overrode the decision of the Tax Court, on the grounds that the decision did not conform to prevailing tax laws and accepted the new evidence submitted by the company that proved intra-group services had been rendered using the arm's length principle in accordance with the OECD Transfer Pricing Guidelines. This evidence showed that ECCO Leather BV (which held 99 per cent of PT. ECCO Tannery Indonesia shares) was an SPV providing centralised services to the group. The Supreme Court found that the trading commission payment therefore fell under paragraph 7.14 of the OECD Transfer Pricing Guidelines.¹⁷⁶ The Supreme Court also found that the Tax Court did not sufficiently examine or test the evidence to support its argument for classifying the trading commission as dividend and categorising it as income, thus breaching Article 91(b) Law No.14/2002.

In another case, however, involving Bekaert Holding BV, the DGT classified an interest payment on a loan to Bekaert Holding BV as dividend, arguing the company had financed itself with an intra-group loan only to reduce its dividend tax payments.¹⁷⁷ By classifying the debt as equity, using a test based on Article 18(3) of the Indonesian Income Law and Article 10 DTA, which defines dividend payments, but the Tax Court ruled in favour of the DGT and accepted the reclassification of the interest as dividend.

6.1.5 Royalties (Article 12 DTA)

Two major questions arise regarding disputes about royalty payments (Article 12 DTA) in the cases under review. Firstly, do 'home office expenses' constitute a royalty or service fee, (PT. Bredero Shaw Indonesia)¹⁷⁸ and secondly, were 'Technical Assistance Fee and Royalty (TARO)' and 'Royalty in Trademark Licenses (RTL)' calculated correctly according to a fairness transaction principle and arm's length principle, in accordance with the OECD Transfer Pricing Guidelines (e.g. Friesland Brands BV).¹⁷⁹

While the tax authority classified the 'home office expenses' (which reduce income and corresponding tax in Indonesia) paid by PT Bredero Shaw Indonesia to its Dutch parent company Bredero Shaw Holding BV as a royalty, the company maintained that home office expenses should be classified as service cost for head office support, based on a service agreement for technical, financial and administrative assistance signed between the two entities. The Indonesian company

176 Para 7.14 of the OECD Transfer Pricing Guidelines states: "Other activities that may relate to the group as a whole are those centralised in the parent company or a group service centre (such as a regional headquarters company) and made available to the group (or multiple members thereof). The activities that are centralised depend on the kind of business and on the organisational structure of the group, but in general they may include administrative services such as planning, coordination, budgetary control, financial advice, accounting, auditing, legal, factoring, computer services; financial services such as supervision of cash flows and solvency, capital increases, loan contracts, management of interest and exchange rate risks, and refinancing; assistance in the fields of production, buying, distribution and marketing; and services in staff matters such as recruitment and training. Group service centres also often carry out research and development or administer and protect intangible property for all or part of the MNE group. These type of activities ordinarily will be considered intra-group services because they are the type of activities that independent enterprises would have been willing to pay for or to perform for themselves."

177 Case 13.

178 Case 5.

179 Case 10.

insisted that the services were indeed delivered by the Dutch entity Bredero Shaw Holding BV from within the Netherlands. In addition, the company argued it did not have a permanent establishment as defined in Article 7(1) DTA in Indonesia, which is required for Indonesia to have taxing rights on the company's business profits.

The Supreme Court dismissed all the arguments filed by PT. Bredero Shaw and found the Tax Authority's correction was in line with Article 12 (3) DTA and Article 4(1)e and Article 26 of the Indonesian Income Tax Law. The Court also declared that the decision of the Tax Court was compatible with Article 91(e) Law No. 14 of 2002.¹⁸⁰

Regarding Friesland Brands BV, the DGT referred to Article 12 of the OECD Model Tax Convention 2005, saying the company violated the arm's length principle and corrected the TARO and RTL because there were signs that these royalty payments had been used in profit shifting.¹⁸¹ The company maintained they had followed the arm's length principle and presented as evidence, research conducted by PricewaterhouseCoopers Netherlands, which showed that a percentage of ten per cent of the net sales price of intellectual property licence was interquartile (within the interval of 1.85 per cent to 3.35 per cent) and therefore consistent with the arm's length principle. The company also had a trademark and licensing agreement with Friesland Brands BV to pay the proprietor a sum of two per cent of the net sales price of all products sold by the licensee (the royalty).

The judges of the Tax Court accepted the Dutch PricewaterhouseCoopers research and approved the appeal submitted by the company, finding that the DGT was unable to prove its claim. The inability of the Authority to present sufficient evidence was a crucial factor in the case.

6.1.6 Taxing business profits (Article 7) of a permanent establishment (Article 5)

Finally, some of the reviewed disputes are about the definition of permanent establishment. Under a DTA only business profits attributed to a permanent establishment (meaning a fixed place of business in which the business of the enterprise is wholly or partly carried out (Article 5)) can be taxed by a source state. The previous section of this report demonstrated how PT. Bredero Shaw Indonesia argued it did not have a permanent establishment in Indonesia and that, as a result, the Indonesian Tax Authority could not tax its business income. The Boskalis case reviewed in this report also referred to permanent establishment criteria (Marcer BP (20, 44915/2013)), and the same argument was used by AGB Nielsen Media Research Netherlands BV.¹⁸²

AGB Nielsen Media Research Netherlands BV (emphasis added), a subsidiary of AGB Nielsen Media Netherlands BV, conducted business in Indonesia and received payment from the Netherlands. The DGT argued that the Rp 517m intercompany service & facilities payment made to the entity

180 Article 91 (e) Law No.14/2002 states: "An application for judicial review can only be submitted on the basis of the following reasons: (e) if a decision clearly does not conform with prevailing tax regulations."

181 Case 10.

182 Case 12.

operating in Indonesia should be subject to taxation in Indonesia, because it was based on an agreement between the two entities, proving that the subsidiary operated as a permanent establishment (*Bentuk Usaha Tetap*) in Indonesia. The Tax Authority therefore classified the received payment as income subject to tax under Article 26 of the Indonesian Income Tax Law. The company had a COD issued by the Dutch tax authorities, making it tax resident in the Netherlands, which without a permanent establishment, according to the company, would make the profits taxable in the Netherlands. The Tax Court approved the appeal filed by the company, making specific reference to the COD.

6.2 Why did the Indonesian tax authorities lose most tax cases in court?

Troublesome application of beneficial ownership

One of the problems identified through the analysis of the court cases is the troublesome application by the judges of the Indonesian Supreme Court of legal concepts in the DTA, for example Beneficial Ownership. In a number of cases, the Indonesian judge considered the Service Providing Companies Decree issued by the Dutch government (SSF) No. IFZ 2004/126M on 11 August 2004 as sufficient proof of Beneficial Ownership. This is particularly troublesome as this decree was never meant to determine Beneficial Ownership. The Decree issued for Service Providing Companies describes the conditions under which the Dutch tax authority will or will not issue rulings on Dutch conduit companies engaged in intermediary financing activities for groups of companies. Related to this is the questionable assumption, put forward by the Indonesian judges of both the Supreme as the Tax Court, that a Certificate of Domicile, in some cases, automatically grants Beneficial Ownership status. This is highly questionable, as those two legal concepts have very different requirements.

Tax treaty undermines Indonesian policy space

The second problem identified is the questionable interpretation of the application of the DTA by the Indonesian DGT. The DTA, that was signed in 2002 and entered into force in 2004, introduced the concept of beneficial ownership. The tax treaty stipulated that, in order to apply for the reduced withholding taxes on dividends, interest and royalties, beneficial ownership was required. It furthermore added that: "The competent authorities of the two States shall by mutual agreement settle the mode of application". As mentioned before, no mutual agreement to settle the mode of application was ever reached¹⁸³, and this requisite was removed with the reform of the 2015 protocol. The problem however was that the DGT, faced with many companies unduly applying to the tax treaty article with the zero withholding tax on interest, tried to annul the application of article 11(4) of the DTA through Circular Letter SE-17/PJ.2005. In the Circular Letter the DGT argues that because Indonesia and the Netherlands did not reach an agreement on the application of Art. 11(2), (3) and (4) of the treaty (Interest), the treaty allows Indonesia to regulate the withholding tax on

183 Letter from the Minister of Foreign Affairs (2015). Protocol tot wijziging van het Verdrag tussen de regering van het Koninkrijk der Nederlanden en de regering van de Republiek Indonesië tot het vermijden van dubbele belasting en het voorkomen van het ontgaan van belasting met betrekking tot belastingen naar het inkomen, en het Protocol daarbij; Jakarta, 29 januari 2002; Jakarta, 30 juli 2015. URL: <https://zoek.officielebekendmakingen.nl/kst-34431-1.html>

interest. Therefore, the Indonesian government unilaterally increased the withholding tax on interest under Art. 11(4) of the treaty from 0 per cent to 10 per cent. However, both the Tax Court and the Supreme Court considered this a clear treaty override, and ruled in favor of the companies that applied for the exemption on withholding tax on interest payments on loans for two years or loans related to sales credit of industrial, commercial or scientific equipment.¹⁸⁴

Limited resources of the tax authority

Another problem identified through analyzing the cases is limited amount of resources available for the tax authority (DGT) to defend their case in court. In many cases the DGT did not sufficiently demonstrate why it considered a particular company not to be the beneficial owner. Furthermore, when contested in court by the specific company, the DGT was sometimes not capable of responding (as for example in the case of Schlumberger Finance BV). It was also mentioned various times in the Tax Court that, when denying beneficial ownership status, the DGT did not sufficiently make use of the principle of 'substance over form' of the Law on Indonesian Income Tax and in accordance with the OECD and UN Commentary on Model Tax Convention.

¹⁸⁴ This is also demonstrated in other research, for example by Eka, W.A. (2017). Beneficial Ownership, lesson learned from Tax Court Verdict. URL: <https://iwayanaguseka.com/2017/06/03/beneficial-ownership-lesson-learned-from-tax-court-verdict/>

7 How telecommunications company Indosat used the Netherlands-Indonesia tax treaty for tax avoidance purposes

An elaboration of the Indosat Ooredoo case allows a better understanding of the specific mechanisms companies use to avoid Indonesian taxes through the Indonesia-Netherlands DTA.¹⁸⁵ The company took advantage of the 0% withholding tax on interest, on loans for two years or loans related to sales credit of industrial, commercial or scientific equipment as agreed in the Indonesia-Netherlands tax treaty, by setting up a Dutch letterbox company to issue US\$ 300 million in bonds.

Indosat Ooredoo, formerly known as Indosat, is an Indonesian telecommunications services and network provider. It is 65% owned by Ooredoo Asia Pte. Lt., 14.29% owned by the Indonesian government with the remaining shares (20.71%) owned by other institutions. In 2003 the company wanted to issue a US\$ 300 million bond to finance its operations in Indonesia. However, if the company would issue the bonds from Indonesia, a 20% withholding tax on the interest payments from the bond would apply. This would mean that the bondholders would receive lower interest payments since they would be taxed.¹⁸⁶ They therefore would demand from Indosat a higher return on their bond, which would make the bond a lot more expensive for the company.

So the company came up with a different plan. Since the Netherlands-Indonesia tax treaty included a 0% withholding tax on interest payments, if Indosat would issue the bond from the Netherlands, no tax would apply at all. To take advantage of the tax treaty, Indosat set up a letterbox company in Amsterdam, with zero employees, managed by the well-known corporate service provider (trust firm) Intertrust.

On 5 November 2003, this letterbox company, "Indosat Finance Company BV", issued a long-term bond for US\$ 300m. The bond was guaranteed by the Indonesian parent company PT Indosat Tbk and some of its subsidiaries. The bond had an interest rate of 7.75 per cent, generating an annual interest cost of more than US\$ 23 million for the Dutch letterbox company.

The exact same day, the Dutch letterbox company entered into a loan agreement with Indonesia-based parent company PT Indosat Tbk for US\$ 300 million. The bond and the loan had identical maturity dates (5 November 2010), the same interest rates (7.75 per cent) and the same interest repayment schedules. This means Indosat used this loan to immediately transfer the funds from the bond in Amsterdam to the parent company in Indonesia.

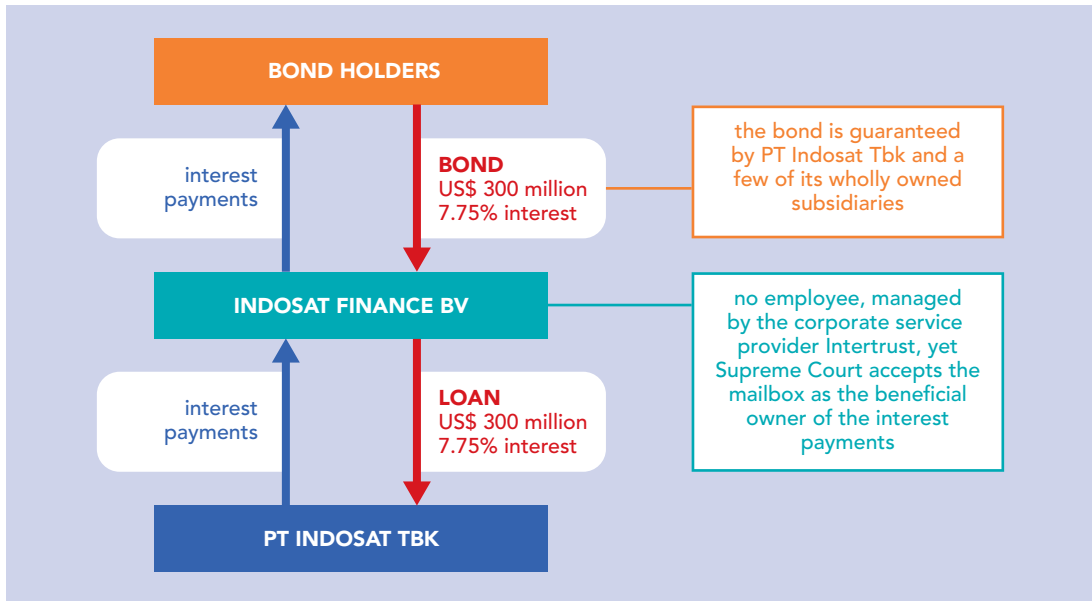
In short, by putting a Dutch letterbox company between the bond financiers and the Indonesian recipients, Indosat benefited from the 0% withholding tax on interest as applied in the Dutch-

¹⁸⁵ Formerly known as PT Indosat Tbk.

¹⁸⁶ Bondholders benefit from the scheme if they are not able to offset the WHT levied in Indonesia on their interest income with a tax credit at home, or if they are exempt from tax together, as is the case for some institutional bondholders.

Indonesian tax treaty at that time. For at least seven years (2003 – 2010) Indosat was able to use this structure. Figure 9 is a graphic representation of the company's financing structure.

Figure 9 Indosat financing structure



Source: Notes 1&2, Indosat Finance BV Annual Account 2009, p. 5, own graphics

In May 2010, the Indonesian Tax Authority challenged the financing structure and accused Indosat of abusing the Indonesia-Netherlands DTA. Indonesia's Tax Court issued a decision denying the application of the 0% withholding tax on interest on loans for two years or loans related to sales credit of industrial, commercial or scientific equipment in the Indonesia-Netherlands tax treaty. The Court argued that PT Indosat incorrectly applied the rates on interest payments to the Dutch letterbox company Indosat Finance Company BV, which was domiciled in the Netherlands during fiscal year 2004, because the letterbox company was not the actual beneficial owner of the income. The Tax Authority had argued that the Dutch letterbox company should actually be deemed an Indonesian tax resident because Indonesia was its place of effective management as its shareholders and place of strategic decision-making were in Indonesia. The Court agreed and ruled that the beneficial owner is the owner that is economically able to enjoy the income. The Court therefore ruled that the letterbox company Indosat Finance Company BV is just a conduit company because it does not enjoy and control the interest it from Indonesia. Therefore, Indosat should not have been able to take advantage of the Indonesia-Netherlands tax treaty and its 0% withholding tax.¹⁸⁷

187 Direktori Putusan (2013). Case 696/B/PK/PJK/2013. URL: <https://www.google.com/url?client=internal-uds-cse&cx=004086544163985272441:foabjpxdue&q=http://putusan.mahkamahagung.go.id/putusan/downloadpdf/7f2ece4449cd111a2e3b1e668f5af5bb/pdf&sa=U&ved=2ahUKewils-E4vfhAhW2ysQBHeqRAIAQFjACegQIDhAB&usg=AOvVaw1nlzPiWag0esavEGYK5Pih>

However, after this decision the case went to the Indonesian Supreme Court. The Supreme Court decided in 2012 that treaty benefits did apply because the Dutch entity fulfilled Dutch substance criteria for international holding companies and service providers.¹⁸⁸ The following box demonstrated the substance requirements fulfilment by Indosat Company B.V. as presented at the Supreme Court.

Box 6 Substance requirements for Service Company Providers and the fulfilment thereof by Indosat Finance Company B.V.

Substance requirements ^{<?>}	Indosat Finance Company B.V. ^{<?>}
At least 50 per cent of the members of the board of directors, with a right to make decisions, live or factually reside in the Netherlands.	The Board of Directors consists of one Indonesian citizen and two Dutch citizens.
The directors residing in the Netherlands have sufficient knowledge to perform their activities in their capacity as a director of the Dutch company. The company has the adequate personnel – either of its own or from third parties – for the adequate execution and registration of the transactions.	That can be proven through a copy of the Fortis Intertrust website that lists the position of employment status and the second position of the Dutch Board of Directors.
The (most important) board decisions are made in the Netherlands.	It can be proven by the minutes of meeting in 6 June 2008 at 7.00 pm. In the minutes it was noted the venue of the meeting was held in Amsterdam, Netherlands.
The (main) bank account of the Dutch company is in the Netherlands.	It can be proven from the checking account with the bank name ABN Amro Bank N.V under the address 1097 Amsterdam and the amount of savings in Euro.
The bookkeeping of the Dutch company takes place in the Netherlands.	That this can be proven through the Ernst & Young Dutch Audit Report stating that Indosat Finance Company BV is based and does bookkeeping in the Netherlands.
The Dutch company has complied with all its tax obligations, at least up to and including the moment of filing the APA/ATR	That this can be proven through the Annual Report of Indosat Finance Company BV
The Dutch company has its registered address in the Netherlands, while the company is, according to its best knowledge, not (also) a resident of another jurisdiction for tax purposes.	It can be proven through the declaration of resident that is The Certificate of Domicile (COD) from the Netherlands Tax Authority.
The Dutch company's minimum equity is adequate in relation to the functions performed (taking into account the risks assumed and assets used). The minimum equity of 1% of the amount of outstanding loans or EUR 2 million per loan.	Equity capital of 2 million Euro. It can be proven through: Management Board Resolution signed in 17 March 2006 stating that there was a capital injection of EUR 1,982,000 thus the previously equity capital of EUR 18,000 added to EUR 2,000,000 and Financial Report; Consolidated Financial Statement by Plaintiff page 15 stating that there was a capital injection to Indosat Finance Company BV.

The Dutch substance requirements regarding ‘Service Company Providers’ were exactly fulfilled by Indosat Finance Company BV, as shown in box 6 above. Throughout the year, one meeting was held in Amsterdam, that was attended by two (Dutch) employees of the trust company ‘Fortis Intertrust’ as well as a director from Indosat’s board. Furthermore, the minimum equity requirement of €2 million was exactly met. The fulfilment of these substance requirements proved for the

188 Supreme Court of the Republic of Indonesia, ruling 696/B/PK/PJK/2013.

Indonesian judge at the Supreme Court that the requirements for beneficial ownership were fulfilled. Therefore, according to the Supreme Court, the Dutch letterbox company was indeed the legitimate beneficial owner of the income from the interest payments. The Dutch substance requirements were however never intended to function as determinants of beneficial ownership.

8 Conclusion and recommendations

8.1 The Indonesia-Netherlands tax treaty is one of Indonesia's biggest tax leaks

Literature on tax avoidance through treaty shopping identifies the Indonesia-Netherlands DTA as a major tax leak. In 2017, the Netherlands was the biggest investor in the world, the second biggest investor in Indonesia whilst the Netherlands' GDP position only had the 18th position. This shows that the Netherlands is used as a so-called conduit country, or offshore investment hub, thanks to its tax-friendly national policies towards multinationals and bilateral tax treaties. The Netherlands is a well-known treaty shopping jurisdiction, used by many large multinational corporations in the world to avoid paying taxes and gain undue investor benefits.

In 2002 Indonesia and the Netherlands agreed on a new version of their DTA, first signed in 1973 and revised in 1993. This new DTA significantly reduced withholding taxes on outgoing dividends (from 15% to 10%) and completely abolished withholding taxes on outgoing interest payments on loans for two years or loans related to sales credit of industrial, commercial or scientific equipment.¹⁸⁹ Especially this second provision led to rampant abuse of the DTA, with companies routing loans through letterbox companies in the Netherlands to avoid taxation on interest payments in Indonesia and lower their profit margin.

This abuse led to a large number of disputes between the Indonesian tax authorities and companies using the tax treaty. This report analyses 27 court decisions on these disputes filed between 2010 and 2015. Except for two cases, all were won by the company either in the Tax Court or after an appeal in the Supreme Court. There are various reasons for why the tax authorities lost their cases. One key factor was the questionable application of legal concepts in the Netherlands-Indonesia tax treaty, such as beneficial ownership. The treaty states that a company can only take advantage of the reduced withholding taxes on dividends, royalties and interest if the company is the beneficial owner of this income, and not just a letterbox or conduit company. In several cases the Indonesian Court argued that a Dutch letterbox company was in fact the beneficial owner (on for instance interest income), but based this on inadequate criteria such as a Certificate of Domicile or specific Dutch substance requirements.

These problems around beneficial ownership partly stem from the fact that the Netherlands and Indonesia never agreed on a common definition of beneficial ownership. The treaty states that the two countries would come to a mutual agreement on the application beneficial ownership, i.e. when a taxpayer in the Netherlands would be considered a letterbox or conduit company, and when a taxpayer would be considered a legitimate business, eligible to take advantage of the lower taxes agreed in the treaty. It was mentioned by the Dutch government that negotiations regarding the

¹⁸⁹ Loans with a term of at least two years or a loan related to sales credit of industrial, commercial or scientific equipment.

mutual agreement on the definition of beneficial ownership endured from 2005 until 2011, but that no agreement was ever reached.¹⁹⁰

The Indonesian tax authorities tried to take unilateral action to stop this abuse of the tax treaty that began in 2002, when the treaty was signed. In 2005 the Indonesian tax authorities issued a Circular Letter stating that a 10% withholding tax rate will now be applied to interest payments on loans for two years or loans related to sales credit of industrial, commercial or scientific equipment, and the exemption agreed in the Netherlands-Indonesia tax treaty would no longer apply.¹⁹¹ In the letter the Indonesian tax authorities state that the Netherlands and Indonesia did not reach any agreement on how the interest tax exemption would be applied. Legally however, this unilateral action is an override of the tax treaty, since tax law prevails over domestic law. Both the Tax Court and the Supreme Court therefore rejected this Circular Letter and ruled in favour of companies that took advantage of the interest exemption.

In 2015 Indonesia and the Netherlands finally reached an agreement on a revised DTA to limit abuse of the treaty. The new treaty now includes a 5% withholding tax rate on interest payments, and states that the two countries no longer need mutual agreement on the application of beneficial ownership regarding dividends, interest and royalties. This 5% WHT on interest payments is still significantly lower than the 10% rate that applies in nearly all other Indonesian tax treaties. The 2015 treaty is therefore in direct contradiction to Dutch policy, which states that it would be willing to offer developing countries higher withholding tax rates. This has been put forward in the circular on Dutch tax treaty policy from 2011.¹⁹² Furthermore, the new treaty does not include anti-abuse measures such as a Principal Purpose Test or a Simplified Limitation on Benefits. The Dutch government did also, in 2013, promise to offer the inclusion of an anti-abuse measure in their tax treaty towards 23 developing countries, including Indonesia.¹⁹³ However, no anti-abuse measure was introduced in the Dutch-Indonesian tax treaty reform of 2015. It is therefore that the tax treaty between the Netherlands and Indonesia is one of the most favorable in terms of low withholding tax rates.

According to the Netherlands, it was Indonesia who preferred not to include anti-abuse measures in the negotiations. The Netherlands-Indonesia tax treaty can therefore still be used for treaty shopping and tax avoidance. The tax revenue lost by the Indonesian government due to such tax avoidance is crucial to the country's development and poverty eradication. Governments in developing countries are much more reliant on corporate taxes to generate revenue for public spending than governments in wealthier countries. This impact is particularly significant for women and girls, who

190 Letter from the Minister of Foreign Affairs (2015). Protocol tot wijziging van het Verdrag tussen de regering van het Koninkrijk der Nederlanden en de regering van de Republiek Indonesië tot het vermijden van dubbele belasting en het voorkomen van het ontgaan van belasting met betrekking tot belastingen naar het inkomen, en het Protocol daarbij; Jakarta, 29 januari 2002; Jakarta, 30 juli 2015. URL: <https://zoek.officielebekendmakingen.nl/kst-34431-1.html>

191 Orbitax (2005). Indonesia – Netherlands. URL: <https://www.orbitax.com/news/archive.php/The-Indonesian-Director-Genera-964>

192 Rijksoverheid, 'Notitie Fiscaal Verdragsbeleid 2011' 11 February 2011, https://www.eerstekamer.nl/behandeling/20110211/_fiscaal_verdragsbeleid_nfv

193 Rijksoverheid, 'Kabinetsreactie op SEO-rapport Overige Financiële Instellingen en IBFD-rapport ontwikkelingslanden', 30 August 2013, available via <https://www.parlementairemonitor.nl/9353000/1/j9vvij5epmj1ey0/vjczkds2b0yf>

are more reliant on publically funded services such as education, and are hit harder by any increases in consumption taxes.

8.2 Tax treaties are outdated and lead to revenue losses

The globalisation and digitalisation of cross-border economic activities and investment have fundamentally changed the nature and practical issues relating to the taxation of internationally operating businesses. Yet treaties, for the past 100 years, have essentially stayed the same. This has created serious loopholes in bilateral treaties, allowing corporations to enjoy lower taxation rates even when they are not economically active in treaty countries, by setting up letterbox companies in jurisdictions that have both a wide treaty network and loose rules regarding incorporation. The OECD has tried to tackle this abuse with its BEPS Project, which includes proposals to end treaty shopping. The Multilateral Instrument, which still has to be applied bilaterally, has recently been signed by almost 90 states in an effort to tackle treaty shopping.¹⁹⁴ It remains to be seen whether its anti-abuse provisions will be an adequate solution to the type of treaty shopping identified in this report. Furthermore, the MLI does not address another problem of tax treaties, namely that these treaties limit the tax rights of source states like Indonesia and result in lower withholding tax rates. The UN model convention tries to address these issues, and is generally favoured by developing countries. This model is not favoured by the Netherlands in its treaty negotiations.

There are strong concerns that bilateral taxation treaties have a negative impact on signatory states, in particular developing countries' domestic revenue mobilisation. Revenue generated by the taxation of corporate income in Indonesia is low, a fact that is attributed to tax avoidance schemes by Indonesian as well as foreign corporations. Research and case studies presented in this report show that Indonesia also suffers revenue losses through treaty shopping. Treaty shopping is the undue granting of preferential rates in tax treaties to foreign or domestic investors that set up letterbox companies to gain access to treaty benefits.

8.3 The introduction of the MLI

Both the Netherlands and Indonesia have signed the MLI. The Netherlands ratified the MLI in March 2019, whereas Indonesia still has to ratify. An important aspect of the MLI is the inclusion of an anti-abuse provision. Both the Netherlands and Indonesia have chosen the default option, the Principal Purpose Test (PPT). The main attraction of the PPT is its simplicity and clarity, it considers whether: '*obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit*'. The problem with its simplicity and straightforwardness is the room it leaves for interpretation and subjective application. There is a considerable chance that individual countries develop different views as to the interpretation of the PPT (Elliffe, 2019).¹⁹⁵ It is recommendable for Indonesia to implement a Simplified LOB, in addition to the default PPT. The SLOB provides several hurdles that have to be taken by taxpayers to apply to the tax treaty

194 Link to updates: <http://www.oecd.org/tax/treaties/beps-ml-signatories-and-parties.pdf>, accessed at January 29th 2019.

195 https://www.ibfd.org/IBFD-Products/Journal-Articles/World-Tax-Journal/collections/wtj/html/wtj_2019_01_int_2.html

benefits. Furthermore, the tests that have to be taken are better specified and leave less room for interpretation. However, it is expected that the implementation of a SLOB, in addition to the PPT, will not be sufficient to address current tax treaty abuses. Time and time again taxpayers have found loopholes to unduly apply to tax treaty benefits. The future will tell to what extent the anti-abuse measure (either the PPT or in combination with the SLOB) are capable of combatting treaty abuse and how they should be combined with domestic anti-abuse legislation. The eventual effect of the MLI on cases of treaty shopping between Indonesia and the Netherlands therefore remains to be seen.

8.4 Domestic reforms are needed in Indonesia and the Netherlands

The 27 Tax and Supreme Court disputes between taxpayers and the Indonesian Tax Authority analysed in this report expose a number of problems in (the application of) the DTA and in Indonesian tax law and practice which allow for the continued use of Dutch conduit entities by foreign and Indonesian corporations to avoid taxation in Indonesia. While the barriers for tax authorities successfully challenging undue granting of treaty benefits to tax payers are found in the treaty text itself, there are currently no strong anti-abuse provisions included in the treaty.

Dutch tax laws and regulations stipulate a number of substance requirements (listed in Chapter 4.2.1) that apply for specific entities. As the cases discussed in Chapter 6 and 7 show, substance requirements are easy to fulfil using letterbox companies, managed by corporate service providers, which have no material presence in the Netherlands. The weak nature of Dutch substance requirements therefore facilitates treaty shopping and is a barrier to tackling avoidance structures in tax treaty disputes in Indonesia.

There are several limitations to the analysis in this report, importantly a lack of transparency of how the judges interpreted the law and the way DGT tried the case. No details of Mutual Agreement Procedures are disclosed to the public, and in the few cases that do make it to court, the decisions of the Tax Court and the Supreme Court provide limited information, beyond statements of facts and conclusions, of the legal reasoning.

Another limitation is the focus on tax disputes only. There may be many more loopholes that create disputes which never make it to court, but nevertheless allow undue treaty benefits and thus tax losses in Indonesia. Furthermore, the focus of this report is the Indonesia-Netherlands DTA so it does not take into account how tax avoidance takes place in a treaty network, where payments and ownership relations are restructured regularly to take advantage of new loopholes and circumvent national policy reforms which attempt to close existing ones. Analysis of other dispute cases have shown, for instance, that the definition of PE for taxation of active income in relation to shipping is a particular problem in the Indonesia-Singapore DTA, as is the classification of technical service fees and its impact on source taxation in the Indonesia-Japan treaty.

In summary, the report concludes that in addition to the need for reforms to the domestic laws of the Netherlands and Indonesia, critical reform of the Indonesia-Netherlands DTA by the Indonesian and Dutch Ministries of Finance is also necessary, including the implementation of a strong anti-abuse provision. Furthermore, the Dutch government should aim for higher withholding taxes in the tax treaty, especially regarding dividend payments in relation to substantial holdings and interest on loans for two years or loans related to sales credit of industrial, commercial or scientific equipment. To tackle abuse, the Indonesian government needs to reform its domestic laws and implement anti-abuse measures, for example through ratifying the MLI. The Dutch government needs to fundamentally reform its legal framework that enables conduit structures, for example by implementing economic nexus requirements in all relevant substance requirements.

More research is needed to analyse tax avoidance loopholes in Indonesia's tax treaty network as a whole. A particular interesting topic is the practice of tax avoidance by multinationals through the use of other tax treaties entered into by Indonesia, for example the one with Singapore. Another interesting topic could be the effect of the anti-abuse measures through the MLI on the (future) use of the Dutch Indonesia tax treaty for tax avoidance purposes.¹⁹⁶

8.5 Policy recommendations – Indonesia

If the Government of Indonesia wants to end treaty shopping and tax avoidance by multinational corporations in Indonesia it should:

1. Accelerate and strengthen the implementation of the Presidential Decree No 13/2018 on beneficial ownership to increase corporate compliance on tax matters

The government of Indonesia issued Presidential Decree No 13/2018 on ultimate beneficial ownership. This decree has, amongst other, the goal to stop money laundering and terrorism funding practices, through unravelling the ultimate beneficial owner of companies. The decree, which was signed by President Joko "Jokowi" Widodo on March 1 2018, requires every corporation (such as Limited Liability Corporations, foundations, associations, firms, and other forms of corporations) to enact, report, and update their corporate beneficial ownership in an effort to prevent tax evasion, tax avoidance, and the use of DTAs as tools for illicit financial flow and other criminal acts. The Government of Indonesia has to take serious action so that public and civil society organizations have access to information on beneficial ownership. Even though there is an initiative to enforce the reporting of beneficial ownership from mining, oil and gas companies through the EITI¹⁹⁷ report, for example, there is no list published of corporate beneficial ownership.

¹⁹⁶ Although the MLI was signed by Indonesia, it has not yet been ratified.

¹⁹⁷ Extractive Industries Transparency Initiative.

2. Approve the semi-autonomous tax authority (proposed in the tax bill) and independent tax court in dealing with the challenges of the taxation issues (transfer pricing, tax evasion and tax avoidance)

The practice of tax evasion, tax avoidance and transfer pricing continues to grow, along with the globalisation of international trade, business competition and increasing advanced technology. The tax authorities need to improve their ability to deal with these issues. The government needs to strengthen the tax authorities by:

- Strengthening cooperation amongst countries to improve the exchange of financial data and information. In the case of transfer pricing by affiliated companies in one country (domestic transfer pricing), it is easier for that country's tax authorities to check the applicable transaction value. However, if the transfer pricing practices are carried out by affiliates based abroad (international transfer pricing), it is difficult to acquire the necessary information. The Indonesian Tax Authority therefore needs to establish cooperation on data and information exchange with other countries, particularly through agreements which improve the exchange of banking financial data which could reveal transfer mispricing practices. In the context of the Indonesia-Netherlands DTA (as revised on July 31, 2015) this issue has already been addressed but better cooperation regarding data and information is still required.
- Strengthening both the capacity and human resources of the Transfer Pricing Unit. The tax authorities should raise the hierarchic level of the Transfer Pricing Unit so that it is on an equal footing with the DGT. The tax authorities should form a special task force team which has the ability to handle transfer pricing issues. The people working for the Task Force should be selected, amongst other factors, on their integrity, in order to stimulate an anti-bribery mentality.
- The disclosure of the names of companies conducting transfer mispricing practices so the public knows which companies are avoiding taxes. If the government (through the tax authorities) and tax court shared cases of transfer mispricing with the public, the public could enforce moral pressure on those companies to change their behaviour.
- Giving the tax authority the powers of a semi-autonomous agency, able and flexible enough to administer and supervise the execution and application of tax regulation. This can be enforced only by approving the tax bill which included a proposal for a semi-autonomous tax agency.

3. Strengthen the Tax Supervisory Committee

Strengthen the role and the responsibilities of the Ministry of Finance's Tax Supervisory Committee in conducting studies, monitoring evaluations, providing advice and recommendations related to DTAs. Furthermore, welcome the representation of civil society organizations to become members of the Tax Supervisory Committee.

4. Empower the role of the media and civil society

Until now, the media has been relatively successful in uncovering cases of transfer mispricing in Indonesia. Several journalists have investigated cases of transfer pricing, though information about these cases has not been made publicly available by the Indonesia tax authorities. Nevertheless, the issue of tax avoidance through transfer mispricing has gained public attention. This attention is essential to creating awareness in Indonesia about tax avoidance, and the subsequent lack of tax revenues, through transfer mispricing.

5. Set up an independent agency to monitor the performance of the DGT

The issue of transfer pricing should be monitored thoroughly and continuously. The disclosures made public by the media on transfer pricing must be widened to include informing independent community-based tax institutions able to monitor the taxation process. These agencies need to be strengthened by improving their organisational capacity, human resources' ability, funding and also their ability to network cooperatively with domestic and foreign institutions as the issue of transfer pricing can be complex. In addition, capable monitoring bodies are required to review transfer pricing cases which, until now, have not been transparent. As well as monitoring, these agencies must also be able to explain in simple terms to the public, the methods of tax evasion and avoidance.

With capable monitoring institutions, the public will know the extent of the ability of the judiciary and tax authorities to deal with transfer pricing. Until now, the solution to problems created by transfer pricing has been political and often far from public expectations. In addition, there are many multinational corporations that still practice transfer mispricing unchallenged by the tax authorities.

6. Review all the Double Tax Agreements (DTAs) with countries that have offshore financial centres and/or high amounts of FDI going into Indonesia

DTAs need to be reviewed to ensure they are still relevant and up to date with current developments, such as the growth of the digital based economy. Because digital based businesses rely heavily on intangible assets, it is easy for them to constantly move their assets. Furthermore, the government needs to maintain a substantial WHT on dividends, interest and royalties in all treaties with countries that have offshore financial centres and/or high amounts of FDI going into Indonesia.

8.6 Policy recommendations – the Netherlands

If the Government of the Netherlands wants to end tax avoidance by multinational corporations through the use of the Indonesia-Netherlands tax treaty it should:

1. Include strong anti-abuse provision in the treaty

Both Indonesia and the Netherlands failed to include anti-abuse provisions in their latest treaty reform (2015 Protocol). To end treaty shopping and tax base erosion using the Indonesia-Netherlands DTA, both countries should include strong anti-abuse provisions. One way to do this is to implement the MLI. When Indonesia ratifies the MLI the default Principal Purpose Test will come into effect. It is strongly recommended for Indonesia to implement a SLOB in its tax treaties, inter alia with the Netherlands. The Netherlands did however not select the SLOB while ratifying the MLI nor granted an asymmetrical application. The Secretary of State of Finance did however mention, in a Parliamentary debate on the MLI, that the Netherlands is willing to apply a bilateral Limitation on Benefits if requested by the other state.¹⁹⁸

2. Introduce more stringent substance requirements in the Netherlands

The Dutch government should accept responsibility for treaty shopping and introduce more stringent substance requirements for granting tax rulings and tax residency. The two additional requirements, introduced in 2018, requiring wage costs of €100,000 and the use of an office space for at least two years, are unlikely to form a serious barrier for large corporations to engage in treaty shopping. The proposal by the Secretary of State to add an ‘economic nexus’ requirement for companies that want to request an international tax ruling is a minimum, but necessary step forward.

3. Implement stronger taxation rights in the Dutch-Indonesian tax treaty

The withholding taxes agreed in the Indonesia-Netherlands DTA are among the lowest of Indonesia’s tax treaties. The WHT on dividend payments in relation to substantial holdings, as well as those on interest payments on loans with a minimum term of two years or loans related to sales credit of industrial, commercial or scientific equipment are just five per cent. Indonesia has 68 double tax treaties in force. Only Hong Kong has the same five per cent rate of WHT on dividend payments related to substantial holdings and only Kuwait, Saudi Arabia and United Arab Emirates have the same WHT rate on loans with a minimum term of two years.¹⁹⁹ The Netherlands should suggest to Indonesia to increase the withholding taxes on the aforementioned dividends and interest payments to at least 15%.

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Annex

Table 7 Withholding tax rates applicable under Indonesian tax treaties (2018)

1	Algeria		15%	15%	15/0%	15%	10%	28 April 1995	1999
2	Australia		15%	15%	10/0%	15/10%	15%	22 April 1992	1993
3	Armenia		15%	10%	10/0%	10%	10%	unknown	2017
4	Austria		15%	10%	10/0%	10%	12%	24 July 1986	1989
5	Bangladesh		15%	10%	10/0%	10%	10%	19 June 2003	2007
6	Belgium		15%	10%	10/0%	10%	10%	16 September 1997	1975
7	Brunei		15%	15%	15/0%	15%	10%	27 February 2000	2003
8	Bulgaria		15%	15%	10/0%	10%	15%	11 January 1991	1993
9	Canada		15%	10%	10/0%	10%	15%	16 January 1979	1980
10	China	2	10%	10%	10/0%	10%	10%	7 November 2001	2004
11	Croatia		10%	10%	10/0%	10%	10%	15 February 2002	2013
12	Czech Republic		15%	10%	12.5/0%	12.50%	12.50%	4 October 1994	1997
13	Denmark		20%	10%	10/0%	15%	15%	28 December 1985	1987
14	Egypt		15%	15%	15/0%	15%	15%	13 May 1998	2003
15	Finland		15%	10%	10/0%	15/10%	15%	15 October 1987	1990
16	France		15%	10%	15/10/0%	10%	10%	14 September 1979	1981
17	Germany	1	15%	10%	10/0%	15/10%	10%	30 October 1990	1992
18	Hong Kong		10%	5%	10/0%	5%	5%	23 March 2010	2013
19	Hungary	3	15%	15%	15/0%	15%	20%	19 October 1989	1994
20	India	1	10%	10%	10/0%	10%	15%	7 August 1987	1988
21	Iran		7%	7%	10/0%	12%	7%	18 February 1990	1996
22	Italy		15%	10%	10/0%	15/10%	12%	30 April 2004	2011
23	Japan		15%	10%	10/0%	10%	10%	3 March 1982	1983
24	Jordan	3	10%	10%	10/0%	10%	20%	12 November 1996	1999
25	Korea (North)		10%	10%	10/0%	10%	10%	10 November 1988	1990
26	Korea (South)	2	15%	10%	10/0%	15%	10%	11 July 2002	2005
27	Kuwait		10%	10%	5/0%	20%	10/0%	23 April 1997	1999
28	Luxembourg	1	15%	10%	10/0%	12.50%	10%	14 January 1993	1995
29	Malaysia	4, 6	10%	10%	10/0%	10%	12.50%	12 January 2006	1987
30	Mexico		10%	10%	10/0%	10%	10%	6 September 2002	2005
31	Mongolia		10%	10%	10/0%	10%	10%	2 July 1996	2001
32	Morocco		10%	10%	10/0%	10%	10%	8 June 2008	2013
33	Netherlands		10/15%	5%	10/5/0%	10%	10%	30 July 2015	2017
34	New Zealand	3	15%	15%	10/0%	15%	20%	25 March 1987	1989
35	Norway		15%	15%	10/0%	15/10%	15%	19 July 1988	1991
36	Pakistan	1	15%	10%	15/0%	15%	10%	7 October 1990	1991
37	Papua New Guinea	1	15%	15%	10/0%	10%	15%	12 March 2010	2015
38	Philippines		20%	15%	15/10/0%	15%	20%	19 April 1982	1983
39	Poland		15%	10%	10/0%	15%	10%	6 October 1992	1994

	Notes	Dividends (Portfolio)	Dividends (substantial holding)	Interest	Royalties	Branch Profit Tax	Date of signature	Entry into force	
40	Portugal		10%	10%	10/0%	10%	10%	9 July 2003	2008
41	Qatar		10%	10%	10/0%	5%	10%	30 April 2006	2008
42	Romania		15%	12.50%	12.5/0%	15/12.5%	12.50%	3 July 1996	2000
43	Russia		15%	15%	15/0%	15%	12.50%	12 March 1999	2003
44	Saudi Arabia		10%	10%	5%/0%	5%	5%	1 January 1989	1989
45	Seychelles	3	10%	10%	10/0%	10%	20%	8 May 1990	1992
46	Singapore		15%	10%	10/0%	15%	15%	27 September 1999	2001
47	Slovakia		10%	10%	10/0%	15/10%	10%	12 October 2000	2002
48	South Africa	3	15%	10%	10/0%	10%	20%	15 July 1997	1999
49	Spain		15%	10%	10/0%	10%	10%	30 May 1995	2000
50	Sri Lanka		15%	15%	15/0%	15%	20%	3 February 1993	1995
51	Sudan		10%	10%	15/0%	10%	10%	10 February 1998	2001
52	Suriname		15%	15%	15/0%	15%	15%	14 October 2003	2014
53	Sweden		15%	10%	10/0%	15/10%	15%	28 February 1989	1990
54	Switzerland	1	15%	10%	10/0%	10%	10%	8 February 2007	1990
55	Syria		10%	10%	10/0%	20/15%	10%	7 June 1997	1999
56	Taiwan		10%	10%	10/0%	10%	5%	25 March 1981	1983
57	Thailand		20/15%	20/15%	15/0%	15%	20%	13 May 1992	1994
58	Turkey		15%	10%	10/0%	10%	10%	15 February 1997	2001
59	Ukraine		15%	10%	10/0%	10%	10%	30 November 1995	2000
60	United Arab Emirates		10%	10%	5/0%	5%	5%	13 March 1974	1976
61	United Kingdom		15%	10%	10/0%	15/10%	10%	11 April 1996	1999
62	United States of America		15%	10%	10/0%	10%	10%	11 July 1988	1988
63	Uzbekistan		10%	10%	10/0%	10%	10%	27 August 1996	1999
64	Venezuela	1	15%	10%	10/0%	20%	10%	27 February 1997	2001
65	Vietnam		15%	15%	15/0%	15%	10%	23 December 1997	2005
66	Zimbabwe	1, 5	20%	10%	10/0%	15%	10%	2012	2005

Source: The table merges the Indonesian Pocket Tax Book 2018 of PwC with the tax treaty network table of Karyadi & Darussalam (2017:1240-1242). The PwC table missed Saudi Arabia and the latter missed Armenia, Laos and Zimbabwe, so that the authors come to a total of 68 treaties.

Notes (from PWC):

- 1 Service fees including for technical, management and consulting services rendered in Indonesia are subject to withholding tax at rates of 5% for Switzerland, 7.5% for Germany, 10% for India, Luxembourg, Papua New Guinea, Venezuela, and Zimbabwe, and 15% for Pakistan.
- 2 VAT is reciprocally exempted from the income earned on the operation of ships or aircraft in international lanes.
- 3 The treaty is silent concerning the branch profit tax rate. The ITO interprets this to mean that the tax rate under Indonesian Tax Law (20%) should apply.
- 4 Labuan offshore companies (under the Labuan Offshore Business Activity Tax Act 1990) are not entitled to the tax treaty benefits.
- 5 Ratified but not yet effective, pending the exchange of ratification documents.
- 6 A protocol amending the tax treaty has been signed, pending the ratification of the protocol and the exchange of ratification documents.

**Table 8 Inward Direct Investment Positions into Indonesia (USD billion, rounded off)
(Top 10 Counterpart Economies)**

Singapore	58	Singapore	62	Singapore	50	Singapore	36
Netherlands	44	Netherlands	33	Netherlands	33	Japan	21
United States	24	United States	22	Japan	21	Netherlands	17
Japan	23	United Kingdom	22	United Kingdom	21	United Kingdom	17
United Kingdom	21	Japan	20	United States	19	United States	15
Malaysia	14	Mauritius	18	Mauritius	15	Mauritius	13
China, P.R.: Hong Kong	8	Malaysia	13	Malaysia	11	Malaysia	11
China, P.R.: Mainland	6	China, P.R.: Hong Kong	8	France	6	France	5
Seychelles	5	France	7	China, P.R.: Mainland	5	China, P.R.: Mainland	5
Korea, Republic of	4	Virgin Islands, British	5	Luxembourg	4	Virgin Islands, British	4

Source: IMF CDIS

**Table 9 Inward and outward direct investment, top 10 reporting countries
(Billion US Dollar, rounded off)**

	Inward Direct Investment (2017)			Outward Direct Investment (2017)		
	FDI	GDP	Ratio	FDI	GDP	Ratio
Netherlands	5,005	825	6.1	6,174	825	7.5
United States	4,025	19,504	0.2	6,013	19,504	0.3
Luxembourg	3,988	62	64.3	4,812	62	77.6
China (mainland)	2,688	11 218	0.2	1,625	2,620	0.6
United Kingdom	1,608	2,620	0.6	1,606	3,677	0.4
China(Hong Kong)	1,581	342	4.6	1,529	342	4.5
Switzerland	1,155	685	1.7	1,495	4,859	0.3
Singapore	1,151	297	3.9	1,452	2,595	0.6
Germany	951	3,677	0.3	1,263	685	1.8
Ireland	893	305	2.9	891	1,646	0.5
Indonesia*	240	1,016	0.2	n/a	1,016	n/a

Source: IMF CDIS (2017)

Table 10 Detailed changes between DTA 1973, DTA 1993, DTA 2002, Protocol 2015

Threshold of PE criteria in the construction sector	183 days	6 months	6 months	6 months
Threshold of PE criteria in the service sector	183 days	3 months	3 months	3 months
Withholding tax rate on dividend:				
- Share ownership of at least 25% (Substantial holdings)	0%	0%	10%	5%
- Share ownership <25% (Portfolio)	20%	20%	10%	15% ^{<7>}
Withholding tax rate on interest:				
- Interest on loan	20%	10%	10%	10%
- If the interest is owed by a bank or a financial institution or by an enterprise mainly engaged in activities in the fields of agriculture, plantation, forestry, fishery, dairy-farming, mining, manufacturing industries, transportation, people's housing projects, tourism, infra-structure or any other field of production, and b) the interest is derived by a bank or a financial institution or by another enterprise.	10%	n.a.	n.a.	n.a.
- Interest on loans for two years or a loan related to sales credit of industrial, commercial or scientific equipment	n.a.	n.a.	exempt	5%
- If paid to the government or to a bank but linked to a government loan agreement or paid to specific financial institutions/banks	n.a.	exempt	exempt	n.a.
Royalties	20%	10%	10%	10%
- if the royalties consist of payments of any kind received as a consideration for the use of, or the right to use, any copyright of scientific work, or industrial, commercial or scientific equipment, or for information concerning scientific experience	10%	n.a.	n.a.	n.a.
- if the royalties consist of payments of any kind received as a consideration for the use of, or the right to use, inventions or discoveries in the field of technology and industry, such as a patent, trade mark, design or model, plan, secret formula or process, or for information concerning experience with respect to production and sale ("know-how").	5%	n.a.	n.a.	n.a.
Branch Profit Tax	n.a.	9% ^{<7>}	10%	10%

