104TH CONGRESS
2d Session

SENATE

EXEC. REPT.
104–36

TAXATION PROTOCOL AMENDING CONVENTION WITH INDONESIA

SEPTEMBER 25, 1996.—Ordered to be printed

Mr. HELMS, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 104–32]

The Committee on Foreign Relations, to which was referred the Protocol, signed at Jakarta on July 24, 1996, amending the Convention between the Government of the United States of America and the Government of the Republic of Indonesia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income with a Related Protocol and Exchange of Notes signed at Jakarta on July 11, 1988, having considered the same, reports favorably thereon, without amendment, and recommends that the Senate give its advice and consent to ratification thereof.

I. PURPOSE

The proposed protocol amends the current treaty between the United States and Indonesia. The principal purposes of the proposed protocol are to modify the treaty to continue to promote close economic cooperation between the two countries, to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country, and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries.

II. BACKGROUND

The proposed protocol to the income tax treaty between the United States and Indonesia was signed in Jakarta on July 24, 1996 (see Treaty Doc. 104–32). The proposed protocol amends the current income tax treaty, with related protocol and exchange of notes,

29–119

between the two countries that was signed in Jakarta on July 11, 1988, and entered into force on December 30, 1990.

The proposed protocol was transmitted to the Senate for advice and consent to its ratification on September 4, 1996. The Senate Committee on Foreign Relations considered the proposed protocol at its Committee business meeting on September 25, 1996.

III. SUMMARY

The current treaty between the United States and Indonesia contains a number of developing country concessions. In particular, the current treaty provides maximum rates of source country tax on certain dividends, interest, and royalties that exceed the rates preferred by the United States. The proposed protocol reduces those maximum rates of source country tax.

The current treaty (as modified by the proposed protocol) is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty ("U.S. model"), [1] and the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model"). However, the current treaty as so modified contains certain substantive deviations from those documents.

IV. ENTRY INTO FORCE

The proposed protocol provides that it will enter into force on the date of exchange of the instruments of ratification. The proposed protocol provides that its provisions will take effect for amounts paid or credited on or after the first day of the second month next following the date on which it enters into force.

V. COMMITTEE ACTION

The Committee on Foreign Relations considered the proposed protocol to the income tax treaty between the United States and Indonesia on September 25, 1996, and ordered the proposed protocol favorably reported by a voice vote, with the recommendation that the Senate give its advice and consent to the ratification of the proposed protocol.

VI. COMMITTEE COMMENTS

The Committee on Foreign Relations believes that the proposed protocol is in the interest of the United States and urges that the Senate act promptly to give its advice and consent to ratification. The committee has taken note of certain issues raised by the proposed protocol, and believes that the following comments may be useful to U.S. Treasury officials in providing guidance on these matters.

The current treaty between the United States and Indonesia contains a number of developing country concessions, some of which

[1] The Treasury Department has withdrawn the U.S. model from use as a model treaty. Accordingly, its provisions may no longer represent the preferred position for U.S. treaty negotiations. Comparison of the provisions of the current treaty as modified by the proposed protocol against the provisions of the U.S. model should be considered in the context of the provisions of comparable recent U.S. treaties with other countries. The Treasury Department's new model, released on September 20, 1996, was released too late for consideration by the Committee in connection with the proposed protocol.

are found in other U.S. income tax treaties with developing countries. The proposed protocol would modify several of the most significant of these concessions.

The proposed protocol reduces the maximum rate of source country tax on dividends from 15 percent to 10 percent if the beneficial owner is a company that is a resident of the other country and that owns directly at least 25 percent of the voting stock of the dividend-paying company. The proposed protocol also reduces the maximum rate of branch taxes that may be imposed by the source country from 15 percent to 10 percent. In addition, the proposed protocol reduces the maximum rate of source country tax on interest and royalties from 15 percent to 10 percent. These reduced maximum rates are closer to, but still generally higher than, the maximum rates of source country tax that would be permitted under the U.S. and OECD models.

The current treaty contains a number of additional developing country concessions that are not modified by the proposed protocol. These concessions include an expanded definition of permanent establishment; a force of attraction rule with respect to business profits; broader source country taxation of personal services income, capital gains of individuals, private pensions, entertainer's income and other income not specifically covered in the current treaty; and the treatment of certain equipment leasing income as royalty income which may be taxed in the source country at a maximum rate of 10 percent.[2]

The committee views the proposed protocol's reduction of the maximum rates of source country tax on dividends, interest, and royalties under the current treaty as a significant move to bring the treaty more in line with general U.S. treaty policy. The fact that a protocol reducing these developing country concession was negotiated so quickly after ratification of the current treaty suggests that such concessions may not, in fact, work to the advantage of the developing country, insofar as they serve to limit the country's attractiveness to potential investors. The committee therefore commends the proposed protocol as an example for future negotiations with developing countries, and reiterates its believe that developing country concessions such as those contained in the current treaty with Indonesia should not be viewed as the starting point for future negotiations with other developing countries.

VII. Budget Impact

The committee has been informed by the staff of the Joint Committee on Taxation that the proposed protocol is estimated to increase Federal budget receipts by less than $10 million annually during the fiscal year 1997–2003 period.

VIII. Explanation of Proposed Protocol

A detailed, article-by-article explanation of the proposed protocol between the United States and Indonesia amending the current treaty is set forth below.

[2] For a more detailed discussion of these concessions and other issues with respect to the current treaty, see Exec. Rept. 101–24, 101st Cong., 2d Sess. (1990).

ARTICLE 1

The proposed protocol amends Article 11 (Dividends) of the current treaty to reduce the maximum rate of source country tax on certain dividends permitted under the treaty.

Internal taxation rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S. source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax on such dividends on a net basis in the same manner as a U.S. person would be taxed.

Dividends paid by a U.S. corporation generally are U.S. source. Also treated as U.S.-source dividends for this purpose are portions of certain dividends paid by a foreign corporation that conducts a U.S. trade or business. The U.S. 30-percent withholding tax imposed on the U.S.-source portion of the dividends paid by a foreign corporation is referred to as the “second-level” withholding tax. This second-level withholding tax is imposed only if a treaty prevents application of the statutory branch profits tax.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A foreign corporation engaged in the conduct of a trade or business in the United States is subject to a flat 30-percent branch profits tax on its “dividend equivalent amount.” The dividend equivalent amount is the corporation’s earnings and profits which are attributable to its income that is effectively connected with its U.S. trade or business, decreased by the amount of such earnings that are reinvested in business assets located in the United States (or used to reduce liabilities of the U.S. business), and increased by any such previously reinvested earnings that are withdrawn from investment in the U.S. business. A foreign corporation is subject to a branch-level excess interest tax with respect to certain “excess interest” of a U.S. trade or business of such corporation; under this rule, an amount equal to the excess of the interest deduction allowed with respect to the U.S. business over the interest paid by such business is treated as if paid by a U.S. corporation to a foreign parent and therefore is subject to the 30-percent withholding tax.

Indonesia

Indonesia generally imposes a 20-percent withholding tax on dividends paid to a nonresident individual or foreign corporation. Indonesia also generally imposes a 20-percent withholding tax on profits of an Indonesian branch of a foreign corporation.

Current treaty rules

The current treaty provides that dividends derived from sources within a treaty country by a resident of the other country may be taxed by both countries. Under the current treaty, the rate of source country tax is limited to 15 percent of the gross amount of the dividends actually distributed if the beneficial owner of the dividend is a resident of the other country.

The current treaty's reduced rate of tax on dividends does not apply if the dividend recipient has a permanent establishment or fixed base in the source country and the shares with respect to which the dividends are paid are effectively connected with the permanent establishment or fixed base. Such dividends are taxed as business profits or income from the performance of independent personal services.

The current treaty permits the imposition of a branch profits tax or a branch-level excess interest tax, but limits the rate of such tax to 15 percent. Under the current treaty, if a company that is a resident of a treaty country has a permanent establishment in the other country, the other country may impose an additional tax in accordance with its law on the after-tax profits attributable to the permanent establishment and on interest payments allocable to the permanent establishment. The rate of such tax may not exceed 15 percent. This limitation does not affect the rate of any such additional tax with respect to production sharing contracts, contracts of work, and any similar contracts relating to oil and gas or other mineral products between the Government of Indonesia or an entity thereof and a resident of the United States.

Proposed protocol rules

The proposed protocol reduces the rate of source country tax that may be imposed on certain dividends from 15 percent to 10 percent. The reduced rate of 10 percent applies to dividends paid by a company that is a resident of one treaty country if the beneficial owner of the dividends is a company that is a resident of the other country and that owns directly at least 25 percent of the voting stock of the dividend-paying company. The rate of source country tax that may be imposed on all other dividends derived from sources in one treaty country by a resident of the other country remains 15 percent.

The proposed protocol reduces the rate of source country tax that may be imposed on the profits attributable to a permanent establishment and on interest payments allocable to a permanent establishment from 15 percent to 10 percent. This reduced rate of 10 percent applies to both the U.S. and Indonesian branch taxes.

ARTICLE 2

The proposed protocol amends Article 12 (Interest) of the current treaty to reduce the maximum rate of source country tax on interest permitted under the treaty and to modify the exemption from source country tax on interest paid to a government or governmental entity of a treaty country.

Internal taxation rules

United States

Subject to several exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent withholding tax on U.S.-source interest paid to foreign persons under the same rules that apply to dividends. U.S.-source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that meets specified foreign business requirements. Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation.

Indonesia

Indonesia generally imposes a withholding tax on interest paid to nonresident individuals and foreign corporations at a rate of 20 percent.

Current treaty rules

The current treaty provides that interest derived from sources within a treaty country by a resident of the other country generally may be taxed by both countries. Under the current treaty, the rate of source country tax is limited to 15 percent of the gross amount of such interest if the beneficial owner of the interest is a resident of the other country.

The current treaty provides for a complete exemption from source country withholding tax in the case of interest derived within such country by the other country or by any agency or instrumentality of the other country not subject to tax by the other country.

The current treaty's reduced rate of tax on interest does not apply if the interest recipient has a permanent establishment or fixed base in the source country and the indebtedness giving rise to the interest is effectively connected with the permanent establishment or fixed base. Such interest is taxed as business profits or income from the performance of independent personal services.

The current treaty addresses the issue of non-arm's-length interest charges between related persons by providing that the amount of interest for purposes of applying this article is the amount of interest that would have been paid to an unrelated person. Any amount of interest paid in excess of such amount is taxable according to the laws of each country, taking into account the other provisions of the treaty.

The current treaty defines the term "interest" as income from bonds, debentures, government securities, notes, or other evidences of indebtedness, whether or not secured by a mortgage or other security and whether or not carrying a right to participate in the debtor's profits. The term also includes income from debt claims of every kind, as well as all other income that is assimilated to income from money lent under the tax law of the country in which the income has it source.

Proposed protocol rules

The proposed protocol reduces the rate of source country tax that generally may be imposed on interest that is derived from sources within one treaty country and that is beneficially owned by a resident of the other country from 15 percent to 10 percent.

The proposed protocol provides that interest arising in one treaty country is taxable only in the other country (and is exempt from source country taxation) to the extent that such interest is derived by the Government of the other country (including a political subdivision and local authority thereof), the central bank of the other country, or a financial institution owned or controlled by the Government of the other country (including political subdivisions and local authorities thereof).

ARTICLE 3

The proposed protocol amends Article 13 (Royalties) of the Convention to reduce the maximum rate of source country tax on royalties permitted under the Convention.

Internal taxation rules

United States

Under the same system that applies to dividends and interest, the United States imposes a 30-percent withholding tax on U.S.-source royalties paid to foreign persons. U.S.-source royalties include royalties for the use of or the right to use intangible property in the United States.

Indonesia

Indonesia generally imposes a 20-percent withholding tax on royalties derived by nonresident individuals and foreign corporations.

Current treaty rules

The current treaty provides that royalties derived from sources within a treaty country by a resident of the other country may be taxed by both countries.

Under the current treaty, the rate of source country tax generally is limited to 15 percent of the gross amount of royalties if the beneficial owner of the royalties is a resident of the other country. For purposes of this 15-percent maximum rate, the term "royalties" means payment of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works (including copyrights of motion pictures and films, tapes or other means of reproduction used for radio or television broadcasting), patents, designs, models, plans, secret formulas or processes, and trademarks. It also includes payment for the use of, or the right to use, information concerning industrial, commercial or scientific experience. In addition, the term includes gain derived from the sale, exchange, or other disposition of any such property or rights to the extent that the amounts realized on such sale, exchange or other disposition are contingent on the productivity, use, or disposition of such property or rights.

In the case of certain amounts treated as royalties, the current treaty limits the rate of source country tax to 10 percent of the gross amount of such royalties. The royalties that are subject to this 10-percent maximum rate are payments by a resident of a treaty country for the use of, or the right to use, industrial, commercial, or scientific equipment (but not including certain ships, aircraft, or containers).

The current treaty reduced rates of tax on royalties do not apply if the recipient of the royalty has a permanent establishment or fixed base in the source country and the property or rights giving rise to the royalty is effectively connected with the permanent establishment or fixed base. Such royalties are taxed as business profits or income from the performance of independent personal services.

The current treaty addresses the issue of non-arm's-length royalties between related persons by providing that the amount of the royalty for purposes of applying this article is the amount of royalty that would have been paid to an unrelated person. Any amount of royalty paid in excess of such amount is taxable according to the laws of each country, taking into account the other provisions of the current treaty.

Proposed protocol rules

The proposed protocol reduces the rate of source country tax that may be imposed on royalties that are derived from sources within one treaty country and that are beneficially owned by a resident of the other country from 15 percent to 10 percent.

ARTICLE 4

The proposed protocol provides that the protocol will be an integral and inseparable part of the current treaty.

ARTICLE 5

The proposed protocol provides that it is subject to ratification and that instruments of ratification will be exchanged as soon as possible. The proposed protocol provides that it will enter into force on the date of exchange of the instruments of ratification. The proposed protocol provides that its provisions will take effect for amounts paid or credited on or after the first day of the second month next following the date on which it enters into force.

IX. TEXT OF THE RESOLUTION OF RATIFICATION

Resolved, (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Protocol, signed at Jakarta on July 24, 1996, Amending the Convention Between the Government of the United States of America and the Government of the Republic of Indonesia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, with a Related Protocol and Exchange of Notes signed at Jakarta on July 11, 1988 (Treaty Doc. 104–32).

X. APPENDIX

WRITTEN STATEMENT OF JOSEPH H. GUTTENTAG, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY, BEFORE THE COMMITTEE ON FOREIGN RELATIONS, U.S. SENATE, SEPTEMBER 24, 1996

Mr. Chairman and Members of the Committee, I am pleased to submit this statement on behalf of the Administration to recommend favorable action on the protocols to two tax treaties, with Indonesia and with the Netherlands with respect to the Netherlands Antilles, that are on the Committee's business meeting agenda. Also on the agenda is the tax treaty with Kazakstan, on which the Administration recommended favorable action in testimony before the Committee on June 13, 1995. There are also three additional bilateral tax treaties that the President has transmitted to the Senate, with Austria, Luxembourg, and Turkey. All these agreements provide significant benefits to the United States, as well as to our treaty partners. Treasury appreciates the Committee's interest in these agreements, and requests the Committee and the Senate to take favorable action at this time on the three agreements that are on the Committee's agenda, and on the remaining three treaties as soon as possible.

The tax treaty program is designed to remove obstacles to international trade and investment, such as double taxation, and to prevent fiscal evasion, such as through treaty shopping and information concealing. Accordingly, tax treaties provide substantial benefits to taxpayers as well as to the fiscs of both treaty partners.

For example, high withholding taxes at source are an impediment to international economic activity. Under United States domestic law, all payments to non-United States persons of dividends and royalties as well as certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Inasmuch as this tax is imposed on a gross rather than net amount, it imposes a high cost on investors receiving such payments. Indeed, in many cases the cost of such taxes can be prohibitive. Most of our trading partners impose similar levels of withholding tax on these types of income.

Tax treaties alleviate this burden by reducing the levels of withholding tax that the treaty partners may impose on these types of income. In general, United States policy is to reduce the rate of withholding taxation on interest and royalties to zero. Dividends normally are subject to tax at one of two rates, 15 percent on portfolio investors and 5 percent on direct corporate investors, with certain exceptions.

The Treasury Department has included in all its recent tax treaties comprehensive "limitation on benefits" provisions that limit the benefits of the treaty to bona fide residents of the treaty partner. These provisions are not uniform, as each country has its own characteristics that make it more or less inviting to treaty shopping in particular ways. Consequently, each provision must to some extent be tailored to fit the facts and circumstances of the treaty partners' internal laws and practices. Moreover, these provisions should be crafted to avoid interfering with legitimate and desirable economic activity. For example, in the future we plan to address directly in our negotiations the issue of how open-end United States regulated investment companies (RICs) should be treated under limitation on benefits provisions in order to facilitate cross-border investments from this important source of capital. Because these funds are required to stand ready to redeem their shares on a daily basis, we believe they generally should be entitled to treaty benefits to the same extent as closed-end RICs, which qualify for benefits under standard limitation on benefits provisions because they are publicly traded on stock exchanges. However, the extent to which this goal may be achieved is likely to vary from treaty to treaty, as the negotiators need to ensure that mutual funds established in the treaty partner cannot be used to promote treaty shopping.

Our tax treaties and treaty positions are subject to continual review. We reexamine the appropriateness and effectiveness of our treaty provisions, and receive comments from both public and private sources. The release last week of the new U.S. model income tax treaty, copies of which were provided to the Committee, is an important step in this process but does not represent its conclusion. The new model represents our favored treaty positions at this time; we will reevaluate and update the model over time as we evaluate model treaty positions as employed in our recent tax treaties and receive comments and further suggestions on the model itself.

DISCUSSION OF PENDING AGREEMENTS—INDONESIA, NETHERLANDS ANTILLES, AND KAZAKSTAN

I would like to discuss the importance and purposes of each agreement that the Committee has set for consideration. We have submitted Technical Explanations of each agreement that contain detailed discussions of each treaty and protocol. These Technical Explanations serve as an official guide to each agreement. We have furnished our treaty partners with a copy of the relevant technical explanation and offered them the opportunity to submit their comments, suggestions and concurrence.

Indonesia

The proposed protocol with Indonesia, which was signed at Jakarta on July 24, 1996, amends the income tax treaty with Indonesia that was signed in 1988 and entered into force on December 30, 1990. In many cases, the withholding tax rates permitted under the existing tax treaty with Indonesia significantly exceed those found in Indonesia's treaties with other OECD countries. This places United States business at a substantial competitive disadvantage in Indonesia relative to competitors from other industrialized countries. Because Indonesia is one of the world's most populous countries, with a rapidly expanding market that is located in a region of dynamic economic growth, it is especially important that United States firms be able to compete there without this disadvantage.

The proposed protocol achieves this objective by reducing the withholding tax rates permitted to bring them into line with those in Indonesia's recent treaties with other OECD countries. The protocol reduces the maximum rates of tax on direct-investment dividends, interest, and royalty income, which are generally 15 percent under the current treaty, to 10 percent.

Netherlands Antilles

Many years ago, the United States and the Netherlands agreed to extend the then treaty between them to the Netherlands Antilles. The extension became a contentious issue, and in 1987 most of the provisions of the treaty as extended to the Netherlands Antilles were terminated, except for the taxation of interest at source and ancillary provisions. The proposed protocol to the Netherlands treaty relates only to the Netherlands Antilles and would complete the termination by eliminating the exemption from the United States withholding tax for interest, except with respect to certain grandfathered debt instruments.

The proposed protocol relating to the Netherlands Antilles would eliminate ongoing treaty shopping through the Netherlands Antilles by limiting the exemption from United States withholding tax to certain debt instruments issued on or before October 15, 1984. These debt instruments were issued in connection with Eurobond offerings by Netherlands Antilles subsidiaries of United States companies, generally before the Deficit Reduction Act of 1984 allowed United States companies to issue debt, free of United States withholding tax, directly into the international capital markets. It is appropriate to provide a continued exemption for these debt instruments because the Eurobonds were issued in reasonable reliance on the continued existence of the exemption and it is believed that eliminating the exemption entirely would have an adverse effect on international capital markets.

Kazakstan

In addition to the five new treaties and protocols, the Committee still has under consideration a treaty between the United States and Kazakstan. This treaty was the subject of a hearing last year. At our request, the Committee delayed its vote on this treaty until we received adequate assurances from the Government of Kazakstan regarding access to bank account information. At the time of last year's hearing, Kazakstan had recently adopted laws permitting the opening of anonymous bank accounts, and we wanted to be certain that the existence of these accounts would not, as a legal or a practical matter, impede our access to bank account information in order to enforce our tax laws.

I am pleased to report that Kazakstan is now clearly moving away from bank secrecy. The Government of Kazakstan has submitted legislation to the Kazakstan Parliament to repeal the earlier laws permitting the establishment of anonymous bank accounts. We understand that the lower house of the Kazakstan Parliament has passed the legislation and that the Government of Kazakstan expects the law to be enacted without opposition this week.

We appreciate the Committee's support on this very important issue and hope that we can work cooperatively to move this treaty forward while at the same time protecting the integrity of the treaty's exchange of information provisions. One alternative that we would support is for the Committee to report the treaty recommending that the Senate give its advice and consent to ratification assuming Kazakstan's adoption of the new law. The full Senate then could approve the recommendation with appropriate conditions concerning the elimination of anonymous bank accounts. We have provided the Committee with the latest information we have regarding the status of this issue and will continue to keep the Committee advised. If the Senate chooses to give its advice and consent to the treaty at the present time, the Administration is willing and able to accept the responsibility of not permitting instruments of ratification to be exchanged until it is fully satisfied that the conditions described above have been fully satisfied. Absent this procedure, entry into force of the treaty could be further substantially delayed. Based on information we have received it would be in the interest of the United States to have the treaty enter into force as promptly as possible.

We will continue to work with the Committee and its staff to bring this issue to a mutually satisfactory conclusion.

CONCLUSION

Let me conclude by again thanking the Committee for its continuing interest in the tax treaty program. We appreciate the assistance and cooperation of the staffs of this Committee and of the Joint Committee on Taxation in the tax treaty process. With your and their help, we have over the past several years brought into force 19 new treaties and protocols.

We urge the Committee to take prompt and favorable action on the three agreements before you at the business meeting. We further urge the Committee to take favorable action as soon as possible on the remaining three tax treaties that the President has submitted to the Senate. Such action will send an important message to our trading partners and our business community. It will demonstrate our desire to expand the United States treaty network with income tax treaties formulated to enhance the worldwide competitiveness of United States companies. It will strengthen and expand our economic relations with countries that have seen significant economic and political changes in recent years. Finally, it will make clear our intention to deal bilaterally in a forceful and realistic way with treaty abuse.

○