[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY (AND PROPOSED PROTOCOL) BETWEEN THE UNITED STATES AND THE REPUBLIC OF INDONESIA

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON JUNE 14, 1990

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed income tax treaty, as modified by the proposed protocol, between the United States and the Republic of Indonesia. The proposed treaty and proposed protocol were both signed on July 11, 1988. The proposed treaty was amplified by an exchange of letters signed the same day. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty on June 14, 1990.

No income tax treaty between the United States and the Republic of Indonesia is currently in force. The proposed treaty amends and replaces a draft proposed income tax treaty between the two countries, with respect to which negotiations originally began in 1971. The original draft of the proposed treaty was to have been signed in 1974, but the signing was postponed pending agreement on a territorial definition of the Republic of Indonesia.

The proposed treaty is similar in substance to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty ("U.S. model treaty"), and the model income tax treaty of the Organization of Economic Cooperation and Development ("OECD model treaty"). However, there are certain substantive deviations from those documents.

In addition, the language and organization of the proposed treaty differ in certain respects from the language and organization of the U.S. and OECD models. This is because the language and organization of the proposed treaty generally is adapted from earlier drafts of the proposed treaty between the two countries, that were negotiated before the Treasury Department adopted its first model treaty patterned after the OECD model treaty.

The first part of this pamphlet summarizes the principal provisions of the proposed treaty and protocol. The second part presents a discussion of issues raised by the proposed treaty and protocol. The third part provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. This is followed in part four by a detailed, article-by-article explanation of the proposed treaty including, where appropriate, explanation of the provisions of the proposed protocol.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and the Republic of Indonesia* (JCS-19-90), June 13, 1990.

I. SUMMARY

In general

The principal purposes of the proposed income tax treaty between the United States and the Republic of Indonesia ("Indonesia") are to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the two countries to cooperate in preventing avoidance and evasion of taxes.

As under other U.S. tax treaties, these objectives are achieved in the proposed treaty principally by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty generally provides that neither country will tax business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 8 and 15). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other are required to pay tax in the other unless their contact with the other exceeds specified minimums (Articles 15 through 20). The proposed treaty provides that gains from the disposition of capital assets (except from the disposition of interests in real property) generally are taxable by the residence country only and not by the source country (Article 14), and that dividends, interest, and royalties received by a resident of either country from sources within the other country generally are taxable by the residence country as well as on a restricted basis by the source country (Articles 11 through 13).

In situations where the source country retains the right to tax income derived by residents of the other country, the proposed treaty generally provides relief from potential double taxation through a credit against taxes owed to the country of residence (Article 23).

Like other U.S. tax treaties, the proposed treaty contains a "saving clause." Under this provision, each country retains the right to tax its citizens and residents as if the proposed treaty had not come into effect (Article 28(3)). In addition, the proposed treaty contains the standard provision that it will not be applied to deny a taxpayer any benefits he or she is entitled to under the domestic law of one of the countries or under any other agreement between the two countries (Article 28(2)); that is, the proposed treaty only applies to the benefit of taxpayers.

The proposed treaty also contains a non-discrimination provision (Article 24) and provides for administrative cooperation and exchange of information between the tax authorities of the two countries to avoid double taxation and to prevent fiscal evasion with respect to income taxes (Articles 25 and 26).

Differences between the proposed treaty and other treaties

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. model and OECD model treaties. The major differences are as follows:

(1) U.S. citizens who are not also U.S. residents generally are not covered by the proposed treaty. The U.S. model does cover such nonresident U.S. citizens; however, the United States rarely has been able to negotiate coverage for them in its income tax treaties.

(2) The U.S. excise tax on insurance premiums paid to a foreign insurer is not covered by the proposed treaty. Although this is consistent with several older U.S. tax treaties, the U.S. model and some recent U.S. treaties, such as the treaties with the United Kingdom, France, and Hungary, generally cover this excise tax. In addition, the excise taxes imposed with respect to private foundations are not covered by the proposed treaty, although they are covered by the U.S. model.

(3) Under the U.S. model, the term United States is defined as the United States of America, but does not include any U.S. possession or territory. The proposed treaty's definition of this term goes beyond the definition in the U.S. model to include those parts of the continental shelf and adjacent seas over which the United States has sovereignty, sovereign rights, or other rights in accordance with international law. However, the U.S. model provision is interpreted to include those territories.

(4) The U.S. model provides that the competent authorities of the two countries shall by mutual agreement determine the country of residence of a person other than an individual or a company that under the proposed treaty is a resident of both countries. The proposed treaty does not contain this provision and is silent with respect to such a dual residency problem. A dual resident company, however, is deemed to be a resident of the country in which it was organized or created.

(5) The definition of a permanent establishment in the proposed treaty is broader in certain respects than the corresponding definition in the U.S. model, the OECD model, and in many existing U.S. treaties. For example, the proposed treaty specifies that a farm, plantation, or warehouse constitutes a permanent establishment, whereas the U.S. and OECD models are silent with respect to these types of facilities. Additionally, the proposed treaty treats as a permanent establishment a building site, construction or installation project (or supervisory activities in connection therewith), or an installation, drilling rig, or ship used for the exploration or exploitation of natural resources that lasts for more than 120 days. The U.S. model and the OECD model provide for a 12-month period before a permanent establishment is created in such cases (except that both models are silent with respect to certain related supervi-

sory activities). Similar provisions reducing the 12-month threshold are found in some other U.S. tax treaties.

The U.S. and OECD models' definitions of a permanent establishment do not specifically address the rendering of services. The proposed treaty provides that a permanent establishment exists with respect to the furnishing of services, including consulting services, through employees or other personnel engaged for such purposes, if the activities related to the furnishing of those services continue for more than 120 days within any consecutive 12-month period. A permanent establishment is deemed not to exist, however, for any taxable year during which such services are rendered in that country for less than 30 days.

(6) The U.S. model provides that a permanent establishment does not include the maintenance of a stock of goods or merchandise in one of the countries belonging to a resident of the other country solely for the purpose of storage, display, or delivery. The proposed treaty includes a similar provision with respect to storage and display, and the proposed protocol provides that a permanent establishment does not include the use of facilities or the maintenance of a stock of goods or merchandise in the other country for the purpose of their occasional delivery. The proposed treaty provides, however, that a resident of one country has a permanent establishment in the other country if the resident utilizes a dependent agent in the other country if the dependent agent has no authority to conclude contracts on behalf of the resident, but habitually maintains in the other country a stock of goods or merchandise belonging to the resident from which the agent regularly fills orders and makes deliveries, and whose additional activities have contributed to the sale of such goods or merchandise.

(7) The proposed treaty contains a provision, not found in either the U.S. or OECD model treaties, stating that an insurance company which is resident in one of the countries is treated as having a permanent establishment in the other country if it uses a person (other than a broker or independent agent acting in the ordinary course of his or her business) in such other country for the purposes of receiving premiums from or insuring risks in that other country. This rule does not apply with respect to reinsurance activities.

(8) The proposed treaty contains a comprehensive set of source rules. These rules, which are in many cases similar to the source rules of internal U.S. law, are used in applying the proposed treaty's source-basis taxation provisions and generally in determining the appropriate foreign tax credit for U.S. and Indonesian taxes.[2] Some U.S. income tax treaties contain similar comprehensive sets of source rules. The U.S. model and the OECD model contain source rules for the interest and foreign tax credit provisions only; local law determines the source of income in other cases.

(9) As a general rule, both the U.S. model and the proposed treaty allow a country (the "source country") to tax the business profits of a resident of the other country only in cases where that person has a permanent establishment located in the first country,

[2] Article 23(1) of the proposed treaty, however, prescribes the use of U.S. domestic law source rules that apply solely for the purposes of limiting the U.S. foreign tax credit.

and then only to the extent that the profits are attributable to that permanent establishment. The proposed treaty further provides, however, that the source country may also tax business profits generated therein by a resident of the other country from sales of goods or merchandise of the same kinds as those that are sold, or from other business transactions of the same kinds as those effected through a permanent establishment maintained by that person in the first country.

(10) The proposed treaty, the U.S. model, and the OECD model all permit a reasonable allocation to a permanent establishment of certain expenses (e.g., general and administrative expenses) incurred by worldwide operations of the person having the permanent establishment. Unlike the two model treaties, the proposed treaty specifically provides that no deduction is allowed with respect to amounts (other than reimbursements for actual expenses) paid by the permanent establishment to its home office or to any of its other offices as royalties, fees, etc., in return for the use of patents or other rights, or as a commission for specific services performed or for management, or as interest on moneys lent to the permanent establishment. The proposed treaty also provides a reciprocal rule so that no consideration is given to payments made by the home office to the permanent establishment.

(11) The shipping and air transport articles of both the U.S. model and the proposed treaty permit only the country of residence to tax income from the operation of ships or aircraft in international traffic. The two treaties contain certain differences, however, with respect to the types of income that qualify for this treatment. Whereas the U.S. model generally treats all profits from the rental of ships or aircraft operated in international traffic as qualifying income, the proposed treaty excludes from this treatment income from the rental of ships (but not aircraft) on a bareboat basis if the lessee is a resident of or a permanent establishment in the other ("source") country. This excluded income is treated as a royalty under the proposed treaty and as such, may be taxed by the source country on a gross basis at a rate of up to 10 percent.

Moreover, the U.S. model treats the profits of a resident of one of the countries from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic as taxable only in the residence country. On the other hand, the proposed treaty permits exemption from source-country tax only if the container leasing income is incidental to other income derived by that person from the operation of ships or aircraft in international traffic. If the income from container leasing is not incidental to ship or aircraft operation, the proposed treaty permits such income to be taxed in the source country on a gross basis as royalty income, at a rate of not more than 10-percent.

(12) The proposed treaty does not contain the usual treaty provision stating that it is not intended to limit any law in either country which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between related persons if such law is necessary to prevent evasion of taxes or to reflect clearly the income of such persons. Such a provision generally serves as clarification that the United States retains the right to

apply its internal intercompany pricing rules (Internal Revenue Code sec. 482) and its rules relating to the allocation of deductions (Code secs. 861, 862, and 863, and applicable regulations). It is understood that the United States retains the right under the proposed treaty to apply its intercompany pricing rules, notwithstanding the omission of the standard provision.

(13) The U.S. model, the OECD model, and many U.S. income tax treaties generally limit to five and 15 percent, respectively, the rates of source-country tax on gross dividends paid to "direct" investors (that is, substantial corporate investors) and "portfolio" investors (that is, investors other than direct investors) resident in the other country. By contrast, the proposed treaty allows up to 15 percent source-country tax on dividends to all investors resident in the other country without regard to their level of ownership. Some U.S. income tax treaties contain similar dividend withholding rates for direct investors.

(14) The proposed treaty generally allows imposition of branch-level profits and interest taxes, whereas the U.S. and OECD models do not.

(15) The proposed treaty generally limits the tax at source on gross interest to 15 percent. Interest beneficially derived by government of either country or their tax-exempt instrumentalities is exempt from source-country tax. By contrast, under the U.S. model all interest generally is exempt from source-country tax. The U.S. model position is often not achieved.

Due to the repeal in 1984 of the U.S. gross-basis withholding tax on interest paid on portfolio indebtedness held by foreign persons, Indonesian residents generally will receive U.S. source interest on portfolio indebtedness free of U.S. tax in any event. U.S. residents, though, generally will be subject to Indonesian tax (limited to 15 percent by the proposed treaty) on Indonesian source interest on similar indebtedness.

In addition, the proposed treaty permits each country to impose a branch-level interest tax on certain amounts of interest expense deducted by a permanent establishment located in that country of a corporation resident in the other country. The rate of branch-level interest tax that may be imposed by a country is limited by the proposed treaty to 15 percent.

(16) The U.S. model and the OECD model generally permit only residence-based taxation of royalty income. Conversely, the proposed treaty allows the source country to also tax such income at a rate of no more than either 10 or 15 percent, depending upon the nature of the royalty. The 15-percent rate applies to income that qualifies as royalties under the general definition of royalties set forth in the U.S. model. The 10-percent rate applies to payments for the right to use industrial, commercial, or scientific equipment (other than ships, aircraft, or containers which are subject to only source-country tax under the applicable article of the proposed treaty (Article 9)). The latter category of income to which the 10-percent rate applies generally is not considered royalty income under the U.S. model. Instead, the U.S. model rules applicable to business profits apply to such income.

(17) The capital gains articles of the U.S. model, the OECD model, and the proposed treaty generally provide for identical

treatment except that under the proposed treaty, the source country is permitted to tax the capital gains of an individual resident of the other country if that individual is present in the source country for at least 120 days during the taxable year in which the gain occurs. Under the U.S. and OECD model treaties, no source-country tax is permitted in this case.

(18) The proposed treaty allows source-country taxation of income derived from the performance of independent personal services on the basis of physical presence in the source country for more than 120 days during any consecutive 12-month period. Neither the U.S. model nor the OECD model allow taxation of such income on the basis of days of physical presence. Under these models, income derived from the performance of independent personal services by a nonresident is taxable in the source country only if the nonresident earns the income through a fixed base in that country.

(19) Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country is not taxable in the source country if three requirements are met: (a) the employee is present in the source country for less than 120 days during any consecutive 12-month period; (b) the individual's employer is not a resident of the source country; and (c) the compensation is not borne or reimbursed by a permanent establishment which the employer has in the source country. Under the U.S. model and the OECD model, the first requirement for source-country tax exemption is less stringent. According to these treaties, the employee may be present in the source country for up to 183 days during the taxable year before his or her income related to services performed in that country is subject to tax there.

(20) The proposed treaty allows the source country to tax entertainers and athletes who earn more than a total of $2,000 there during any consecutive 12-month period, without regard to the existence of a fixed base or other contacts with the source country. The comparable annual total in the U.S. model treaty is $20,000, and is measured on a taxable year basis. The OECD model, while also permitting source-country taxation of such income, does not provide a dollar threshold below which imposition of the tax would not be allowed. Many U.S. income tax treaties follow the U.S. model's taxable-year rule, but use a lower annual income threshold.

(21) The proposed treaty removes from the scope of the article on entertainers and athletes (Article 17) remuneration from activities conducted in one country (the "source country") by residents of the other country if their visit to the source country is substantially supported or sponsored by the other country and is certified by the competent authority of the other country as qualifying under this special provision. In such a case, the income is subject to either the business profits or independent personal services article, as appropriate. Neither the U.S. model nor the OECD model contains a similar provision.

(22) The exemption from host-country taxation provided under the proposed treaty to visiting students and trainees is broader than the corresponding exemptions provided in the U.S. and OECD

models. The U.S. model exemption applies only to payments received from outside the host country for maintenance, education, study, research, or training. The proposed treaty exemption extends to, among other things, $2,000 per year of personal services income in the case of a student, and $7,500 per year of personal services income in the case of a trainee. The proposed treaty exemption is similar to that incorporated in a number of older U.S. income tax treaties.

(23) The proposed treaty includes an article that exempts certain income earned by teachers and researchers from tax in the country where such services are performed (the "source country") if the persons providing those services are residents of the other country immediately prior to entering the source country (Article 20). The U.S. model contains no such provision.

(24) The proposed treaty allows both the United States and Indonesia to tax the private pension of an individual resident of one of the countries if that pension is in consideration of past employment performed within the other country (the "source country"). In such a case, the source country may not tax the income at a rate higher than 15 percent. The U.S. and OECD models permit only residence-country taxation of private pensions.

(25) The proposed treaty permits only the country of residence of the payor of alimony and child support payments to tax those payments if made to a resident of the other country. While the U.S. model contains the same rule with respect to taxation of child support payments, it allows only the country of residence of the recipient to tax payments of alimony.

(26) The U.S. model and the OECD model extend to the residence country the exclusive right to tax income not otherwise specifically dealt with under the respective treaties, unless the income is attributable to a permanent establishment or a fixed base in the other country. The proposed treaty does not contain a specific article dealing with other income, and provides as a general rule of taxation that a resident of one of the countries may be taxed by the other country on any income (and only on such income) from sources within that other country, subject to any specific limitations contained in the proposed treaty.

(27) The anti-treaty shopping provisions of the proposed treaty resemble to some extent those of the U.S. model. Certain differences exist between the two provisions, however. For example, the U.S. model requires more than 75 percent of the beneficial interest of a non-public company resident in one of the countries to be owned by individual residents of that country in order to qualify for treaty benefits. On the other hand, the proposed treaty reduces the ownership threshold to more than 50 percent; and those who must own the threshold percentage include not only individual residents of the country in which the company is resident, but also individual residents of the other country, U.S. citizens, public companies, and the governments of the two countries. A 50-percent threshold is also contained in the anti-treaty shopping provisions of section 884(e)(4) of the Code (relating to the branch-level profits and interest taxes), as well as in other recent treaties.

II. ISSUES

The proposed treaty, as amended by the proposed protocol, presents the following specific issues:

(1) Treaty shopping

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty is intended to benefit residents of Indonesia and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source-country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of U.S. tax on interest by lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing a subsidiary, trust, or other investing entity in that treaty country, which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty shopping provision of the proposed treaty is similar to an anti-treaty shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties, including the treaties that are the subject of this hearing. Some aspects of the provisions, however, differ either from the anti-treaty shopping provisions of the U.S. model or from the anti-treaty shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. An issue, then, is whether the proposed anti-treaty shopping provisions effectively forestall potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed treaty is more lenient than the comparable rule in the U.S. model and certain other U.S. treaties. The U.S. model allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the country of residence, while the proposed treaty (like several recent treaties and an anti-treaty shopping provision in the Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country and citizens of the United States. Thus, this safe harbor is considerably easier to enter under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country does not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits. In addition, a base erosion test contained in the proposed treaty provides protection from many potential abuses of an Indonesian conduit.

Another provision of the proposed treaty's anti-treaty shopping article conforms to the comparable rules of the U.S. model, but not the comparable rule in treaties negotiated more recently. The general test applied by the U.S. model to deny benefits is a broad one, looking to whether the acquisition, maintenance, or operation of an entity had "as a principal purpose obtaining benefits under" the treaty. By contrast, the Treasury has more recently sought in negotiations a more precise test that allows denial of benefits with respect to income not derived in connection with the active conduct of a trade or business.

The practical difference between the two tests depends upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, a trade or business test could be interpreted to require a more active or less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be more strict than a broad reading of an active business test (i.e., would operate to deny benefits in potentially abusive situations more often).

In practice, however, the opposite may be more likely. The IRS may find it relatively difficult to sustain a narrow reading of the principal purpose test. In litigation involving Code section 367, for example, which utilized a principal purpose test until 1985, courts have consistently refused to apply this test to transactions where taxpayers could claim any business purpose. Given that possibility, it may well be that a business purpose test would prove more strict than the test contained in the proposed treaty.

The United States should maintain its policy of limiting treaty shopping opportunities whenever possible, and in exercising any latitude Treasury has to adjust the operation of the proposed treaty it should satisfy itself that its rules adequately deter treaty shopping abuses. The provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Indonesia since those investors may be unwilling to share ownership of such investing entities on an equal basis with U.S. or Indonesian residents or other qualified owners to meet the ownership test of the anti-treaty shopping provision. The Committee should satisfy itself that the provision, as proposed, is an adequate tool for preventing possible treaty-shopping abuses either now or in the future.

(2) Developing country concessions

The proposed treaty contains a number of developing country concessions, some of which are found in other U.S. income tax treaties with developing countries. The most significant of these concessions are listed below.

Definition of permanent establishment

The proposed treaty departs from the U.S. and OECD model treaties by providing for relatively broad source-basis taxation. The proposed treaty's permanent establishment article, for example, permits the country in which business activities are carried on to tax the activities sooner, in certain cases, than it would be able to under either of the model treaties. Under the proposed treaty, a building site or construction, assembly, or installation project (or supervisory activities related to such projects) creates a permanent establishment if it exists in a country for more than 120 days; under the U.S. model, a building site, etc., must last for at least one year. Thus, for example, under the proposed treaty, business profits attributable to an installation project in Indonesia are taxable by Indonesia if the project lasts for more than 120 days. Similarly, under the proposed treaty, the use of a drilling rig in a country for more than 120 days creates a permanent establishment there; under the U.S. model, drilling rigs must be present in a country for at least one year in order to constitute a permanent establishment.

Moreover, the proposed treaty contains a 120-day permanent establishment threshold with respect to the furnishing of services in one of the countries. Although the U.S. model is silent with respect to the determination of a permanent establishment in cases involving services, the preferred treaty position of the United States in conventions with developing countries has been a minimum of 183 days.

The 120-day periods set forth in the proposed treaty are significantly less than the 183-day periods which are utilized in most tax treaties between the United States and developing countries. It is understood that the periods used in the proposed treaty are the result of a compromise between the 183-day periods preferred by the United States and 90-day threshold periods preferred by Indonesia.

Finally, the proposed treaty contains a special provision that in certain cases treats an insurance company resident in one of the countries as having a permanent establishment in the other country if it receives premiums from or insures risks in that other country.[3] This rule applies unless the risks are insured through a broker or independent agent operating in the ordinary course of his or her business. Thus, for example, if a U.S. insurance company insures, through an employee, risks located in Indonesia, then the income generated from the insurance of those risks may be taxed by Indonesia under the business profits article of the proposed treaty. A similar provision is found in the United Nations' model treaty.

Source-basis taxation

Concessions to source-basis taxation in the proposed treaty include maximum rates of source-country tax on interest (15 percent) and royalties (either 10 or 15 percent, depending on the nature of the royalty) that are higher than those provided in the U.S. model

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[3] This special rule does not apply to reinsurance activities, however.

treaty, although they represent reductions from the rates of tax that U.S. investors in Indonesia would be required to pay absent a treaty. Also, the proposed treaty permits taxing jurisdiction on the part of the source country as well as the residence country with respect to income not otherwise specifically dealt with by the proposed treaty, and broader source-country taxation of personal services income, capital gains of individuals, private pensions, and entertainers' income than that allowed by the U.S. model.

Taxation of business profits

Under the U.S. model and many other U.S. income tax treaties, a country may tax the business profits of a resident of the other country only to the extent those profits are attributable to a permanent establishment situated within the first country. The proposed treaty expands the definition of business profits beyond the traditional definition to include profits that are derived from sources within the country where a permanent establishment exists from sales of goods or merchandise *of the same kinds as those sold, or from other business transactions of the same kinds as those effected, through the permanent establishment.* This reference to similar transactions is taken from the U.N. model treaty. It should be noted that although this rule provides for broader source-basis taxation than does the rule contained in the U.S. model, it is in some ways less broad than the general "force of attraction" rule of Code section 864(c)(3).

Certain equipment leasing

In addition to containing the traditional definition of royalties which is found in most U.S. tax treaties (including the U.S. model), the proposed treaty provides that royalties include payments for the use of, or the right to use, industrial, commercial, or scientific equipment. These payments are often considered rentals by other treaties, subject to business profits rules which generally permit the source country to tax such profits only if they are attributable to a permanent establishment located in that country. In such case, the tax is computed on a net basis. By contrast, the proposed treaty permits gross-basis source-country taxation of these payments, at a rate not to exceed 10 percent, if the payments are not attributable to a permanent establishment situated in that country.[4]

Issues presented

One purpose of the proposed treaty is to promote direct investment by U.S. firms in Indonesia by eliminating tax barriers, thereby enhancing a free flow of investment capital between the two countries. The practical effect of these developing country concessions could be greater Indonesian taxation of future activities of U.S. firms in Indonesia than would be the case under the rules of either the U.S. or OECD model treaties.

The issue is whether these developing country concessions are appropriate U.S. treaty policy and, if so, whether Indonesia is an appropriate recipient of these concessions. There is a risk that the

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[4] If the payments are attributable to such a permanent establishment, then the business profits article of the proposed treaty applies.

inclusion of these concessions in the proposed treaty could result in additional pressure on the United States to include them in future treaties negotiated with other developing countries. A number of existing U.S. treaties with developing countries already include developing country concessions, however. Such concessions are arguably necessary in order to obtain treaties with developing countries such as Indonesia. It may be argued that tax treaties with developing countries are in the interest of the United States because they provide tax relief for U.S. investors and a clearer framework within which the taxation of U.S. investors will take place.

(3) Treatment of income from container leasing

For the most part, the article of the proposed treaty dealing with shipping and air transport follows closely the corresponding article of the U.S. model in that residents of one country generally are exempt from taxation by the other country on income derived from the operation of ships or aircraft in international traffic. The proposed treaty excludes from the shipping exemption certain income from the use or maintenance of containers ("container leasing income"), and therefore treats such income as royalty income rather than shipping income. Specifically excluded from the definition of income from shipping is income from the use or maintenance of containers and related equipment for the transportation of containers, unless that income is incidental to income derived from the operation of ships or aircraft in international traffic. Thus, for example, a U.S. company that engages in international shipping operations and earns a relatively minor amount of income from the leasing of containers used in international traffic is exempt from Indonesian tax on that income under the proposed treaty. By contrast, a U.S. company whose sole operation involves the leasing of containers used in international transport is not granted the same exemption. Income from such operations is treated as royalty income under the proposed treaty, and to the extent that it is sourced in Indonesia may be subject to a gross-basis withholding tax in Indonesia at a rate of up to 10 percent.

This special rule regarding container leasing income differs from the provision of the U.S. model which treats income from container leasing as transportation income, generally taxable only by the residence country. Under the OECD model treaty, container leasing income (along with income from the rental of other equipment) is treated as royalty income which is exempt from taxation in the source country. In addition, the OECD subsequently published a view that container leasing income should be treated as ordinary business profits, which would be exempt from taxation in the source country in the absence of a permanent establishment.

Rules regarding container leasing income similar to the provisions contained in the proposed treaty are included in two current U.S. income tax treaties: the treaties with Australia and New Zealand. Although the Senate Foreign Relations Committee approved both of these treaties in 1983, it did so despite making specific mention of its serious concern regarding the container leasing provisions. In fact, the Committee advised the Treasury Department, in any future negotiations, to take all necessary steps to conform future treaties to the U.S. model on this issue.

In 1983, the Committee expressed concern that by departing from the U.S. model on this issue, members of the U.S. container leasing industry were adversely affected. It specified a number of reasons why such a departure was of concern, some of which appear to be equally applicable to the provision contained in the proposed treaty. First, permitting source country taxation of container leasing income represents a significant departure from U.S. treaty policy as expressed in the U.S. model treaty and from general U.S. practice. Second, inclusion of this provision seems to indicate that there is some justifiable distinction between container leasing income and other transportation income, although at the time the Committee considered the Australian and New Zealand proposed treaties, it did not believe that any such justifiable distinction existed. Third, this provision allows the source country to impose a gross withholding tax that might exceed net income in certain cases. Fourth, the 1983 committee report states that the provision places container leasing companies at a competitive disadvantage vis-a-vis shipping companies who lease containers in international traffic as an incidental part of their business, and who are exempt from source country tax on those container leases under the proposed treaty.

To the extent that under present Indonesian law, Indonesia imposes a gross-basis withholding tax on container leasing income, inclusion of the provision in the proposed treaty that would permit Indonesia to impose such a tax on certain U.S. persons could place those persons at a competitive disadvantage when compared to other persons who operate containers, but who are exempted by the proposed treaty from Indonesian tax on income derived therefrom. On the other hand, if Indonesia currently does not impose such a tax on those persons, they may not be so disadvantaged, unless Indonesia were to subsequently amend its internal laws. If this is the case, however, the possibility that Indonesia might take such future steps may warrant consideration by the Committee.

(4) Source-country taxation of direct investment dividends

U.S. tax treaties, including the U.S. model, often provide for two separate rates of source-country taxation of dividends. In most cases, treaties provide for a lower source-country tax rate for dividends in the case of direct investment than in the case of portfolio investment. For example, the U.S. model provides for a 5-percent rate on direct investment dividends and a 15-percent rate on other dividends. For this purpose, direct investment generally is defined as beneficial ownership by a company of at least 10 percent of the voting stock of another company.

Separate treaty rates are established in recognition of the different tax treatment that generally is imposed on income from portfolio investment vis-a-vis income from direct investment. In many cases involving countries with double-level tax systems, income from direct investment by corporations is provided favorable tax treatment in order to limit the number of levels of unlimited taxation to two. For example, under U.S. law, certain dividends received by corporations are allowed a dividends received deduction (sometimes up to 100 percent of the dividend), whereas individual shareholders are usually subject to tax on the entire amount of the dividend received. Furthermore, a dividend received from a foreign corporation by a U.S. corporation that is a direct investor generates an indirect foreign tax credit. That is, the U.S. corporate recipient of the dividend is allowed to credit some portion of the foreign taxes paid by the distributing foreign corporate against its U.S. tax liability.

The Committee may want to consider whether a reduced dividend withholding rate on direct investment dividends is desirable, necessary, and obtainable. As stated previously, one of the purposes of the proposed treaty is to facilitate investment by U.S. persons in Indonesia. To the extent that a 15-percent Indonesian tax rate on direct investment dividends causes direct investment in Indonesia to be viewed as less favorable than other investment opportunities available to U.S. corporations, the goal of enhanced U.S. investment in Indonesia may not be achieved. However, the reopening of negotiations on this point would delay the time when taxpayers will know if and whether the rules of the proposed treaty will apply to their transactions.

(5) U.S. tax on certain stock gains of foreign persons

The United States does not currently impose tax on U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real estate. The treaty provides that gains of Indonesian residents (who are present in the United States for less than 120 days during the taxable year) are exempt from U.S. tax unless they are (1) gains from the disposition of U.S. real property interests; (2) gains from the alienation of personal property which are effectively connected with a permanent establishment or a fixed base in the United States; or (3) gains from the alienation of a right or property which are contingent on the productivity, use, or disposition thereof. Thus, if an Indonesian person without a U.S. permanent establishment or fixed base owns stock in a U.S. corporation, any gains from the disposition of that stock generally will be exempt from U.S. tax under the treaty, regardless whether U.S. internal law is changed to provide for such a tax, unless that change is specifically intended to override treaties.

In 1989, the House of Representatives passed a bill that would have taxed the gain on a disposition by a foreign person of stock in a U.S. corporation if the foreign person holds or held more than 10 percent of the stock of the U.S. corporation at any time during the 5 years prior to the disposition.[5] This provision, had it been enacted into law, would have yielded to contrary existing treaties for a 3-year period and then overridden them subsequently. In the committee report on this provision, however, it was anticipated that in some cases, it could have been desirable for the United States to enter into treaties that would modify the effect of the provision on treaty country residents.

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[5] H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989). The provision was deleted in conference.

The override provision was considered by the Administration to be a serious defect in the bill, putting aside the more basic tax policy question whether such gains of foreign persons should be exempt in all cases from U.S. tax, when dividends paid by U.S. corporations to foreign persons are not, or whether or not it would be more appropriate to tax gains no more favorably than dividends.

Bills have been introduced this year in both Houses of Congress that would tax as effectively connected income gains derived by foreign persons from the sale of stock of domestic corporations in cases where the foreign person holds or held at least 10 percent of the stock of the domestic corporation.[6] Unlike the unsuccessful House bill provision of 1989, the 1990 bills generally do not override existing contrary treaties. The proposed treaty would thus prevent the operation of the bill vis-a-vis Indonesian residents if the bill is passed.

The issue is whether it is advisable to enter into a treaty that forbids a tax that the Congress may decide to impose as the result of a change in its internal tax law policy. Although prior Congresses may have believed that the gains realized by foreign persons from the disposition of stock in U.S. companies were properly excluded, as a statutory matter, from the U.S. tax base, whether for reasons of administrability or for other reasons, Congress may decide that it is no longer appropriate to do so in the case of substantial foreign shareholders in U.S. companies. The Congress could further decide that, just as it is inappropriate in treaties to reduce source-country taxation of dividends to zero, it is similarly inappropriate to reduce to zero the rate of tax on gains from stock that pays such dividends, or that it is inappropriate to reduce such tax to zero in all cases and for all types of dispositions.

Alternatively, the Congress could decide that, while a tax on stock gains should be imposed by statute, it may properly be waived in treaties, or at least treaties with countries that, in Congress's view, impose an adequate level of tax on the types of stock gains of its residents that would otherwise be subject to tax under the statute. As reflected in the OECD model and many existing treaties, for example, countries that do impose tax on the stock gains of foreign persons often waive such taxes in treaties, although because of differences in definitions of the term "gains" in other countries, those treaties may not operate in precisely the same manner as a U.S. income tax treaty, using U.S. definitions of the term "gain," would operate. (The U.S. model treaty also provides for waiver of the tax, but the U.S. model was last revised at a time when such a waiver would not have reduced any U.S. tax otherwise imposed by the Code, and thus could only have reduced foreign country taxes.)

It is understood that Indonesia does not impose a tax on stock gains of foreign persons. Thus, prohibition of that tax in the proposed treaty may not be viewed as a benefit to U.S. taxpayers (or the U.S. fisc) at the expense of the Indonesian fisc. However, if both countries were to at some point in the future impose such a tax, then it might be argued that such a prohibition would most

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[6] H.R. 4308, sec. 201, 101st Cong., 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess. (1990).

likely represent a benefit to U.S. taxpayers (or the U.S. fisc), in light of the balance of investment flows between the two countries. If the Senate agrees to a treaty with Indonesia, and then Congress enacts the stock gains tax that the treaty protects Indonesian residents from paying, it is unclear whether the United States and Indonesia would agree, in subsequent treaty negotiations, to retention or removal of the treaty restriction on each country's tax on stock gains of foreign persons. Consideration might be given, by both parties to the treaty, to questions such as whether Indonesia at that time imposed a similar tax under its internal law and how the imposition or elimination of such a tax by the United States (and by Indonesia, if applicable) is likely to affect the taxation by Indonesia of U.S. residents, as well as the taxation by the United States of Indonesian residents.

The Committee might address this issue in alternative ways. First, the Committee might recommend that the Senate consent to the treaty notwithstanding this issue. It is not clear if or when Congress will enact a tax on foreign persons' stock gains; if Congress does not do so, then there will have been no need for the Committee to take notice of this issue. In addition, the Committee might conclude that the waiver contained in the proposed treaty is in the best interests of the United States.

Alternatively, if the Committee believed that it should preserve the right, in whole or in part, to tax an Indonesian's U.S. stock gains and that Indonesia should be free to tax, in whole or in part, U.S. persons' Indonesian stock gains, the Committee could seek a reservation allowing the United States to impose a tax on stock gains at a rate no less than that imposed on dividends, to limit the amount by which the tax on stock gains could be reduced, or to limit the cases in which it could be eliminated. This course, while it could allow the United States to collect the tax (if enacted), could also present a condition that the Indonesian Government finds unacceptable. Therefore, this course could delay or prevent the benefits of the treaty.

Third, the Committee could delay action on the treaty while it awaits legislative progress on the pending bills. This course would delay the time when taxpayers will know if and whether the rules of the proposed treaty will apply to their transactions.

(6) Code section 864(c)(6)

The Internal Revenue Code, as amended by the 1986 Act, provides that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year (sec. 864(c)(6)). Thus, where a sale of property that was used by a foreign person in its U.S. trade or business (or in certain treaty cases, in its U.S. permanent establishment) generates deferred payments, some of which are received after the U.S. trade or business (or permanent establishment) has ceased to exist, this provision of the Code permits the United States to impose tax on those deferred payments on the basis of how those payments would have been treated for U.S. tax purposes in the year of sale. Prior to the 1986 Act change, taxpayers could avoid U.S. tax by entering into deferred payments sales in this manner.

Neither the U.S. model treaty nor the OECD model treaty contain a provision similar to section 864(c)(6). However, the single U.S. treaty that has been updated by provisions now in force to take into account the 1986 Act amendments, namely, the U.S.-France treaty, does permit imposition of the rule. In addition, many of the proposed treaties that are the subject of this hearing also contain similar provisions (e.g., the proposed treaties with Finland, Germany, India, Spain, and Tunisia).

Generally, the preferred U.S. treaty policy currently is to include a provision similar to section 864(c)(6) in U.S. income tax treaties. The issue is whether the proposed treaty will be viewed as a precedent by other countries, where those countries would seek to limit, in treaties, imposition of U.S. tax under the principles of Code section 864(c)(6). The Committee may wish to express its view as to the proper treatment of this rule in future treaties.

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. It also discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

The United States taxes U.S. citizens, U.S. residents, and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income that is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and certain limited classes of foreign source income that are effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income.")

Income of a nonresident alien or foreign corporation that is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected. A foreign corporation is also subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. A foreign corporation is also subject to a branch-level interest tax, which amounts to a flat 30 percent of the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

U.S. source fixed or determinable annual or periodical income of a nonresident alien or foreign corporation (including generally interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. In the case of certain insurance premiums earned by such persons, the tax is one or four percent of the premium paid. The gross-basis tax imposed on U.S. source noneffectively connected income paid to foreign persons is collected by means of withholding (hence these taxes are often called withholding taxes).

These taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. In addition, certain statutory exemptions from the 30-percent tax are provided. For example, interest on deposits with banks or savings institutions is exempt from tax unless such interest is effectively connected with the conduct of a U.S. trade or business. Exemptions are provided for certain original issue discount and for income of a foreign government or international organization from investments in U.S. securities. Additionally, certain interest paid on portfolio obligations is exempt from the 30-percent tax. Where the Code or treaties eliminate tax on interest paid by a corporation to certain related persons, the Code generally provides for denial of interest deductions at the corporate level to the extent that the corporation's net interest expenses exceed 50 percent of adjusted taxable income. The amount of the disallowance is limited, however, by the amount of tax-exempt interest paid to related persons.

U.S. source noneffectively connected capital gains of nonresident individuals and foreign corporations generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the sale of interests in U.S. real property.[7]

The source of income received by nonresident aliens and foreign corporations is determined under rules contained in the Internal Revenue Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S. source income. However, if during a three-year testing period a U.S. corporation or U.S. resident alien individual derives more than 80 percent of its gross income from the active conduct of a trade or business in a foreign country or possession of the United States, then interest paid by that corporation is foreign source rather than U.S. source income. Moreover, even though dividends paid by a corporation meeting this test are U.S. source, a fraction of each dividend corresponding to the foreign source fraction of the corporation's income for the three-year period is not subject to withholding tax. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign source income. However, in the case of a dividend paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business, a portion of such dividend is considered U.S. source income. The U.S. source portion of such dividend generally is equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. (No tax is imposed, however, on a foreign recipient to the extent of such U.S. source portion unless a treaty prevents application of the statutory branch profits tax.)

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be

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[7] In addition, bills have been introduced in Congress that would tax as effectively connected income gains derived by foreign persons from the sale of stock of domestic corporations in cases where the foreign person held at least a threshold amount (i.e., 10 percent) of the stock of the domestic corporation (H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989); H.R. 4308, sec. 201, 101st Cong., 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess., (1990)).

either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises, and other like property).

Double taxation of income can arise under the U.S. tax system, because income earned abroad by a U.S. person may be taxed both by the country in which the income is earned and by the United States. The United States seeks to mitigate this double taxation by generally allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis. Pursuant to rules enacted as part of the Tax Reform Act of 1986 (the "1986 Act"), the overall limitation is computed separately for certain classifications of income (e.g., passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the averaging of foreign taxes on certain types of foreign source income traditionally subject to high foreign taxes against the U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on oil and gas extraction income.

Prior to the 1984 Act, a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply only to 50-percent U.S.-owned foreign corporations. In order to prevent a similar technique from being used to average foreign taxes among the separate limitation categories, the 1986 Act provided look-through rules for the characterization of inclusions and income items received from a controlled foreign corporation.

Prior to the 1986 Act, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient foreign tax credits and no domestic taxable income (whether or not the taxpayer had economic income from domestic operations). In order to mandate at least a nominal tax contribution from all U.S. taxpayers with substantial economic income, the 1986 Act provided that foreign tax credits cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction). However, as amended by the Omnibus Budget Reconciliation Act of 1989, no such limitation is imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. These taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited, subject to the various separate income limitations and the overall limitation.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign source income, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

The objective of limiting double taxation generally is accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents. The treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally is not subject to primary taxing jurisdiction as a resident by each of the two countries. Treaties also provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other are not required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent tax and seeks to reduce or eliminate this tax in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "saving clause". Double taxation can also still arise because most countries do not exempt passive income from tax at the source. This double taxation is mitigated either by granting a credit for income taxes paid to the other country or, in the case of some U.S. treaty partners, by providing that income is exempt from tax in the country of residence. The United States in its treaties allows a credit against U.S. tax for income taxes paid to the treaty partners, subject to the limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between the countries is further assured under the treaties by the inclusion of a competent authority mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

At times, residents of countries without income tax treaties with the United States attempt to use a treaty to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

Tax treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that which it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither country may discriminate against enterprises owned by residents of the other country.

IV. EXPLANATION OF PROPOSED TAX TREATY

Set forth below is a detailed, article-by-article explanation of the proposed income tax treaty and, where applicable, the proposed protocol between the United States and Indonesia, followed by an explanation of the letters exchanged when the proposed treaty and protocol were signed.

Article 1. Personal Scope

Generally, the proposed treaty applies to residents of the United States or Indonesia or of both countries. For purposes of the proposed treaty, the definition of a resident of the United States or Indonesia is set forth in the article on fiscal residence (Article 4). There are certain exceptions to the general application of the proposed treaty to residents of the United States or Indonesia. For example, the article dealing with general rules of taxation (Article 28) provides, among other things, that either country reserves the right to tax its citizens (and in certain cases former citizens) or residents in accordance with its domestic laws as if the proposed treaty was not in effect. In addition, other provisions of the proposed treaty such as provisions related to source of income (Article 7), related persons (Article 10), non-discrimination (Article 24), and the exchange of information (Article 26) may apply to persons not specified in Article 1.

Article 2. Taxes Covered

In the case of Indonesia, the proposed treaty applies to the income tax (pajak penghasilan 1984), including the company tax (pajak perseroan 1925) to the extent provided in such income tax, and the tax on interest, dividends, and royalties (pajak atas bunga, dividen dan royalty 1970).

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed under the Internal Revenue Code (the "Code"). It does not apply, however, to the accumulated earnings tax, the personal holding company tax, or social security taxes. In addition, the proposed treaty generally does not apply to non-income taxes such as excise,[8] unemployment, estate, or gift taxes. Likewise, State and local taxes are not covered by the proposed treaty.

The proposed treaty contains a provision generally found in U.S. income tax treaties to the effect that it also will apply to any identical or substantially similar taxes that either country may subsequently impose.

[8] The excise tax imposed on insurance premiums paid to foreign insurers is not covered under the proposed treaty, although this tax is a covered tax under the U.S. model treaty, as well as under some recent U.S. income tax treaties (e.g., the treaties with France, Hungary, and Cyprus). The preferred U.S. treaty position for many countries does not include coverage of this excise tax.

Notwithstanding these general rules, the non-discrimination provisions of the proposed treaty (Article 24) apply to all taxes of every kind imposed at the national level by the United States or Indonesia. In addition, the exchange of information provisions of the proposed treaty (Article 26) apply to all taxes of every kind imposed by the two countries at the national level.

Article 3. General Definitions

The proposed treaty contains certain of the standard definitions found in most U.S. income tax treaties.

The term "Indonesia" means the Republic of Indonesia. The term also includes, when used in a geographical sense, the adjacent seas over which the Republic of Indonesia has sovereignty, sovereign rights, or jurisdiction in accordance with the provisions of the 1982 United Nations Convention on the Law of the Sea.

The "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. When used in a geographical sense, the term includes the 50 States, the District of Columbia, and those parts of the continental shelf and adjacent seas over which the United States has sovereignty, sovereign rights, or other rights in accordance with international law.

The term "one of the Contracting States" or "the other Contracting State" means Indonesia or the United States, as the context requires.

The term "person" is defined to include an individual, a partnership, a company, an estate, a trust, or any other body of persons.

The term "company" means any corporation or any entity which is treated as a corporation for tax purposes.

The Indonesian competent authority is the Minister of Finance, or his authorized representative.

The U.S. competent authority is the Secretary of the Treasury or his authorized representative. The U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Assistant Commissioner (International). On interpretive issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS.

The terms "Indonesian tax" and "United States tax" mean the taxes imposed by the two countries to which the proposed treaty applies pursuant to the article setting forth taxes covered (Article 2). These terms do not include penalty or interest charges. However, under the proposed treaty's provisions for mutual agreement procedure (Article 25), the competent authorities of the two countries may attempt to ensure that penalties or interest are imposed or paid in a manner consistent with the objectives of the proposed treaty.

The proposed treaty defines "international traffic" as any transport by a ship or aircraft, except where the transport is solely between places in the other country. Accordingly, with respect to an Indonesian enterprise, purely domestic transport in the United States is excluded from this definition.

The proposed treaty provides that any term which it does not define is to have the meaning it has under the applicable law of the country applying the proposed treaty, unless the context otherwise requires. If the meaning of an undefined term under one country's law is different from its meaning under the other country's law, or is not readily determinable under either country's law, the competent authorities of the two countries may establish a common meaning for the undefined term.

Article 4. Fiscal Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as the term is defined by the proposed treaty. Furthermore, double taxation is often avoided by the proposed treaty assigning one of the countries as the country of residence where, under the laws of the countries, a person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his or her worldwide income, whereas a nonresident alien is taxed only on U.S. source income and on income that is effectively connected with a U.S. trade or business. A company is a resident of the United States if it is organized in the United States. Under the standards for determining residence provided in the 1984 Act, an individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident. A permanent resident for immigration purposes also is a U.S. resident. The standards for determining residence provided in the 1984 Act do not alone determine the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States).

Under the proposed treaty, the term "resident of a Contracting State" means any person who under the laws of either Indonesia or the United States is subject to tax in that country as a resident by reason of his or her domicile, residence, place of incorporation, place of management or any other criterion of a similar nature. For purposes of United States tax, a partnership, estate, or trust is considered a resident of the United States only to the extent that its income is subject to tax, either in its hands or in the hands of its partners or beneficiaries, as the income of a U.S. resident. For example, if the share of United States beneficiaries in the income of a United States trust is only one-half, Indonesia would have to reduce its withholding tax (to the extent required by the applicable provision of the proposed treaty) on only one-half of the Indonesian source income paid to the trust. A similar rule is not required in the case of Indonesia because it is understood that under its internal tax laws, partnerships and trusts are taxed as corporations, and estates are taxed as individuals. The references to "subject to tax" mentioned above do not cause a tax-exempt organization to lose its status as a resident of one of the countries under the proposed treaty.

Under this article of the proposed treaty, a U.S. citizen is not considered a U.S. resident for treaty purposes. As a result, U.S. citizens residing overseas (in countries other than Indonesia) generally are not entitled to the benefits of the proposed treaty as U.S. residents. Only in very few U.S. income tax treaties has the United States negotiated coverage for nonresident U.S. citizens.

The fiscal residence article also provides a set of "tie-breaker" rules to determine residence in the case of an individual who, under the general residence rules, is considered a resident of both the United States and Indonesia. These rules are similar to those contained in the U.S. model treaty. In the case of a dual resident individual, that individual is deemed for all purposes of the proposed treaty to be a resident only of the country in which the individual has his or her permanent home (that is, the place where an individual dwells with his or her family), the center of his or her vital interests (i.e., his or her closest economic and personal relations), his or her habitual abode, or his or her citizenship. If the residence of an individual cannot be determined by these tests, applied in the order stated, the competent authorities of the two countries are to settle the question of residence by mutual agreement.

If a company (as defined in Article 3) is considered a resident of both Indonesia and the United States under the general residency determination rules, then for purposes of the proposed treaty, it is treated as a resident of the country in which it is organized or incorporated.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that, subject to certain modifications, generally follows the pattern of other recent U.S. income tax treaties, the U.S. model treaty, and the OECD model treaty.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in that other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties apply, or whether those amounts are taxed as business profits.

In general terms, under the proposed treaty, a permanent establishment is a fixed place of business through which a resident of one country engages in business in the other country. A permanent establishment includes (but is not limited to) a place of management, branch, office, factory, workshop, farm,[9] plantation, warehouse, mine, oil or gas well, quarry, or other place of extraction of natural resources. A permanent establishment also includes a building site, construction, assembly, or installation project, or supervisory activities in connection therewith, or an installation, drilling rig, or ship used for the exploration or exploitation of natural resources, but only if the site, project, drilling rig, etc. lasts for more than 120 days. In addition, a permanent establishment includes the furnishing of services, including consultancy services,

[9] The treatment of a farm as a permanent establishment is contrary to the U.S. model treaty which provides that income from agricultural operations are taxed as income from immovable (real) property, rather than as business profits. Nevertheless, the result is taxation on a net basis in either case.

through employees or other personnel engaged for such purposes, but only where such activities continue with respect to that or a related project for more than 120 days within any consecutive 12-month period. A permanent establishment does not exist, however, as a result of the furnishing of such services in any taxable year in which the services are rendered in that country for a period or periods aggregating less than 30 days (although such period of days are included in determining whether the 120-day test is met).

The general permanent establishment rule is modified to provide that a fixed place of business in one country which is used by a resident of the other country only for any or all of a number of specified activities does not constitute a permanent establishment. These activities include the use of facilities solely for storing or displaying merchandise belonging to the resident; the maintenance of a stock of goods belonging to the resident solely for storage or display or for processing by another person; and the maintenance of a fixed place of business solely to purchase goods or merchandise or to collect information for the resident. Additionally, the maintenance of a fixed place of business solely for the purpose of advertising, the supplying of information, scientific research, or similar preparatory or auxiliary activities for the resident does not, in and of itself, constitute a permanent establishment. Moreover, pursuant to the proposed protocol, the use of facilities or the maintenance of a stock of goods or merchandise belonging to an enterprise for the purpose of occasional delivery of such goods or merchandise does not constitute a permanent establishment.[10]

If a resident of one country maintains an agent in the other country who has, and habitually exercises, the authority to conclude contracts in that other country on behalf of the resident, then the resident generally is deemed to have a permanent establishment in that other country. This rule does not apply where the contracting authority is limited to those activities, such as storage, display, or delivery of merchandise (described in the preceding paragraph) that are excluded from the definition of permanent establishment. Additionally, if the resident maintains an agent in the other country who lacks the authority to conclude contracts on behalf of the resident, but who habitually maintains in the other country a stock of goods or merchandise owned by the resident from which he or she regularly fills orders or makes deliveries and who conducts additional activities which contribute to the sale of the goods or merchandise, then the resident is deemed to have a permanent establishment in the other country. The proposed treaty contains the usual provision that the agency rule does not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business.

The fact that a company which is a resident of one country controls, or is controlled by, a company which is a resident of the other country or which is engaged in business in that other country (whether through a permanent establishment or otherwise)

[10] A permanent establishment would exist, however, if such a facility were used for the purpose of making deliveries on a regular basis.

does not in and of itself constitute either company a permanent establishment of the other.

The proposed treaty provides a special rule for the determination of the existence of a permanent establishment in the case of companies engaged in insurance activities. Generally, if an insurance company that is a resident of one of the countries earns premiums from, or insures risks in, the other country, then it is considered to have a permanent establishment in that other country. This general rule does not apply to reinsurance contracts or in cases where the insurance is provided through a broker, general commission agent, or any other independent agent located in the other country and acting in the ordinary course of business.

Article 6. Income from Immovable (Real) Property

The proposed treaty provides that income from immovable (i.e., real) property, including income in respect of the operation of mines, oil or gas wells, quarries, or other natural resources, and gains derived from the sale, exchange, or other disposition of such property or of the right giving rise to such income, may be taxed by the country in which the immovable property or natural resource is situated. For purposes of the United States, this rule includes, where applicable, the branch-level taxes imposed under Code section 884. Additional rules regarding the taxation of dispositions of immovable property are provided in the article on capital gains (Article 14).

Interest on indebtedness secured by immovable property or secured by a right giving rise to income in respect of the exploitation of natural resources is not regarded as income from immovable property. Such amounts are subject to the provisions of the article on interest (Article 12). Income derived from the usufruct, direct use, letting, or use in any other form of real property is regarded as income from immovable property. The provisions of this article are applicable to the income from immovable property of an enterprise, as well as to such income used for the performance of independent personal services, even in the absence of a permanent establishment.

Although an election to compute tax on income from immovable property on a net basis is often included in U.S. tax treaties (and is included in the U.S. model treaty), no such election is provided for in the proposed treaty. It is understood that the internal laws of both the United States and Indonesia generally provide for net-basis taxation of such income, however.

Immovable property income may also be taxed by the country of residence. In such a case, residence-country taxation is subject to relief from double taxation (Article 23).

Article 7. Source of Income

The proposed treaty contains a comprehensive set of rules, similar to rules found in certain other U.S. tax treaties, to determine the proper source of income. Source rules are provided for eight different types of income. These rules are relevant in determining whether one of the countries may assert jurisdiction to tax the income on the basis that the income arose within that country. The rules are also relevant to a determination of the appropriate foreign tax credit allowed under the proposed treaty (Article 23). The U.S. model treaty contains source rules for the foreign tax credit and interest provisions only; local law determines the source of income in other cases under the model.

Under the proposed treaty, dividends paid by a U.S. corporation are U.S. source, and dividends paid by a Indonesian corporation are Indonesian source.

Interest paid by a governmental authority or resident of one of the countries generally is sourced in that country. However, if the interest expense is borne (deducted) by a permanent establishment of the payor in one of the countries, the interest is sourced in the country in which the permanent establishment is located, even if the payor of the interest is not a resident of either of the countries. Thus, for example, this rule treats as U.S. source income, interest paid (and deducted) by the U.S. branch of a bank organized in a country other than the United States or Indonesia.

Royalties (as defined in Article 13) for the use of, or the right to use, property or rights within one of the countries are sourced in that country.

Income from immovable (real) property (as defined in Article 6) is treated as income from the country in which the immovable property which gives rise to the income is situated.

Rentals from tangible personal (movable) property, except for rentals of ships, aircraft, or containers used in international traffic, are sourced in the country where the property producing the income is used. Rental income from ships, aircraft, or containers used in international traffic is either taxable only in the state of residence as set forth in the article on shipping and air transport (Article 9), or is defined as royalty income (Article 13) and sourced according to the royalty sourcing provisions previously detailed.

Income (including pensions) from personal services generally is sourced in the country where the services are performed. However, income from personal services performed aboard ships or aircraft operated by a resident of one country in international traffic is treated as income from sources within that country if rendered by a member of the regular complement of the ship or aircraft. Social security payments (Article 22) are sourced within a country only if paid by or from public funds of a governmental authority of that country.

Income from the purchase and sale of a real property interest is sourced in the country in which the real property is located or deemed located.

Any of these source rules may be overridden if the income consists of industrial or commercial profits which are attributable to a permanent establishment which the recipient, a resident of one of the countries, has in the other country. In such case the income is sourced in the country in which the permanent establishment is located. This source rule applies to income from real property and natural resources, dividends, interest, royalties, and capital gains, as well as to other industrial and commercial profits, but only, in each case, if the property or rights giving rise to the income are effectively connected with the permanent establishment. Article 8 (Business Profits) sets forth factors to be taken into account in determining whether property or rights giving rise to income are "effectively connected" with a permanent establishment for treaty purposes.

Some of the proposed treaty's source rules differ somewhat from those of the Code. Under Article 28 (General Rules of Taxation), the proposed treaty only applies to benefit taxpayers; thus, a taxpayer is not required to apply a treaty source rule in determining its U.S. tax liability if the corresponding Code source rule would produce a more favorable result. A taxpayer may not, however, make inconsistent choices between the Code and treaty source rules. See Rev. Rul. 84-17, 1984-1 C.B. 308 (applying a similar rule under the Polish income tax treaty).

If the source of any item of income is not covered by the proposed treaty rules, each country will determine the source according to its own law. If the two countries apply different rules, however, or if the source is not readily determinable under the laws of one country, the competent authorities of the two countries may establish a common source for the item of income for purposes of the proposed treaty.

Article 8. Business Profits

U.S. Code rules

U.S. law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages) and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected income.

In the case of foreign persons other than insurance companies, foreign source income is treated as effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. For such purposes, only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends and interest, either derived in the active conduct of a banking, financing, or similar business in the United States, or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office.

The foreign source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code may be treated as U.S.-effectively connected without regard to the foregoing rules, so long as such income is attributable to its United States business. In addition, the net investment income of such a company which must be treated as effectively connected with the conduct of an insurance business within the United States is not less than an amount based on a combination of asset/liability ratios and rates of return on investments experienced by the foreign person in its world-wide operations and by the U.S. insurance industry.

Except in the case of a dealer, trading in stocks, securities, or commodities in the United States for one's own account does not constitute a trade or business in the United States and, accordingly, income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S.-based employee, a resident broker, commission agent, custodian, or other agent or trading by a foreign person physically present in the United States.

The Code, as amended by the 1986 Act, provides that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year. In addition, the Code provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business.

Proposed treaty rules

Under the proposed treaty, business profits of a resident of one country are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the resident carries on business activity or to the extent that such profits are derived from sources within the other country from the sales of goods or merchandise of the same kind as those sold, or from other business transactions of the same kinds as those effected, through the permanent establishment. This is one of the basic limitations on a country's right to tax income of a resident of the other country.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits, and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.

The proposed treaty does not contain a provision that would permit a country to tax profits and income that are attributable to a resident of the other country's permanent establishment or fixed base located, during its existence, in first country, if the payments of such profits or income are deferred until the permanent establishment or fixed base has ceased to exist. Thus, the proposed treaty does not permit the United States to tax profits under Code section 864(c)(6).

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there are to be attributed to a permanent establishment the business profits that would reasonably be expected to have been derived by it if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with its home office. For example, this arm's-length rule applies to transactions between a permanent establishment and an office of the resident enterprise located in a third country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions are allowed for all expenses reasonably connected with the profits, wherever incurred. These deductions include a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred by the home office for purposes of the enterprise as a whole to the extent that such amounts are reasonably connected with the profits of the permanent establishment. Thus, for example, a U.S. company that has a branch office in Indonesia but its head office in the United States is, in computing the Indonesian tax liability of the branch, entitled to deduct a portion of the executive and general administrative expenses incurred in the United States by the head office for purposes of administering the branch. No such deduction, however, is allowed for amounts paid by the permanent establishment to the head office (or any other of its offices), by way of royalties, fees, or other similar payments for the use of patents or other rights. Additionally, no such deduction is allowed for payments made by the permanent establishment to such parties as commissions for specific services performed, as fees for management, or as interest on funds loaned to the permanent establishment. Similarly, payments of the types specified above, if made by the home office (or any other office) to the permanent establishment are disregarded by the permanent establishment in computing its profits unless such amounts represent reimbursements for actual expenditures incurred by the permanent establishment on behalf of the home office or such other offices.

No profits are attributed to a permanent establishment merely by reason of the purchase of merchandise by the permanent establishment for the account of the resident of which it is a permanent establishment. Thus, if a permanent establishment purchases goods for its head office, the profits attributed to the permanent establishment with respect to its other activities are not increased by a profit element on its purchasing activities.

Where business profits include items of income that are dealt with separately in other articles of the proposed treaty, those other articles, and not this article, generally govern the treatment of those items of income.

Article 9. Shipping and Air Transport

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries providing reciprocal tax exemptions for shipping and aircraft income.

Under the proposed treaty, income that is derived by a resident of either country from the operation of ships or aircraft in international traffic generally is exempt from tax by the other country. International traffic includes any transportation by ship or aircraft, except transportation solely between places in one of the countries (Article 3(1)(h) (General Definitions)). The exemption applies whether or not the income is attributable to a permanent establishment in one of the countries.

The exemption applies to income from the rental of ships or aircraft in international traffic on a full basis, the rental of aircraft operated in international traffic on a bareboat basis, and the rental of ships operated in international traffic on a bareboat basis unless the lessee of such ship is a resident of, or has a permanent establishment in, the other country.[11] The payments covered by the exception are treated as royalties under the proposed treaty (Article 13). This exception is a departure from the U.S. model, which permits an exemption from source-country tax regardless of whether a ship is operated on a full or bareboat basis, and without consideration of the place of residence (or the existence of a permanent establishment) of the lessee.

In the case of income derived from the use or maintenance of containers (and related equipment for the transportation of containers), and the containers, equipment, etc. are used to transport goods or merchandise in international traffic, the exemption from source-country tax applies only if such income is incidental to income derived from the operation of ships or aircraft in international traffic. Thus, for example, a U.S. company that engages in international shipping operations and earns a relatively minor amount of income from the leasing of containers which are used in international traffic is exempt from Indonesian tax on that income under this article. By contrast, a U.S. company whose sole operation involves the leasing of containers which are used in international transport is not granted the same exemption. Income from such operations is treated as royalty income under the proposed treaty, and to the extent that it is sourced in Indonesia is subject to the provisions of Article 13. This special rule regarding income from container leasing differs from the provision of the U.S. model

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[11] Rental on a full or bareboat basis refers to whether or not the ship or aircraft is leased fully equipped, manned and supplied.

which treats container leasing income as transportation income, generally taxable only by the residence country.

If a resident of one country derives gain from the disposition of a ship or aircraft which was operated in international traffic, or from the disposition of a container or related equipment necessary for the transport of a container which was used in international traffic, then such gain is only taxable by the country of residence. This provision applies, rather than the provisions of the article on capital gains (Article 14), with respect to such dispositions.

According to the proposed protocol, the two countries have agreed that nothing in the proposed treaty shall prejudice the legal rights of residents of either country to pursue claims concerning the taxation by the other country of income from the operation of ships or aircraft in international traffic for taxable years beginning before the proposed treaty enters into force.

Article 10. Related Persons

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision similar to section 482 of the Code that recognizes the right of each country to make an allocation of income, deductions, credits, or allowances to that country in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements that would have been made between independent persons.

For purposes of the proposed treaty, a person is related to another person if either person participates directly or indirectly in the management, control, or capital of the other, or if any third person or persons participates directly or indirectly in the management, control, or capital of both. For this purpose, the term "control" includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

Where, pursuant to this article, one country includes in the profits of its resident, and taxes accordingly, profits on which a resident of the other country has been subjected to tax in that other country, then that other country, if it agrees that the adjustments made by the first country reflects arm's-length principles, is to make an appropriate adjustment to the amount of the tax charged on its resident on those profits. In determining such adjustment, the other country is to give due regard to the other provisions of the proposed treaty and, if necessary, the competent authorities of the two countries will consult with each other.

The proposed treaty omits the usual treaty provision stating that this article is not intended to limit any law in either country that permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between non-independent persons if such law is necessary to prevent evasion of taxes or to reflect clearly the income of those persons. That provision generally clarifies that the United States retains the right to apply its intercompany pricing rules (Code sec. 482) and its rules relating to the allocation of deductions (Code secs. 861, 862, and 863, and applicable regulations). It is understood that the United States retains the right under the proposed treaty to apply its internal intercompany pricing rules, notwithstanding the omission of the standard treaty provision.

Article 11. Dividends

In general

This article generally reduces to 15 percent the rate of tax that one of the countries can levy on the gross amount of dividends from sources within that country paid to residents of the other country. The proposed treaty provides that the dividend-recipient's country of residence may also tax the dividend under its internal laws.

U.S. taxation of dividends paid to foreign persons

The United States generally imposes a 30-percent withholding 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 like a U.S. person at the standard graduated rates, on a net basis. For purposes of the 30-percent tax, U.S. source dividends are dividends paid by a U.S. corporation (other than a corporation that has elected status as a possession corporation under Code section 936). Also treated as U.S. source dividends for this purpose are certain dividends paid by a foreign corporation, if at least 25 percent of the gross income of the foreign corporation, in the prior three-year period, was effectively connected with a U.S. trade or business of that foreign corporation. The tax imposed on the latter dividends is often referred to as the "second-level" withholding tax.

For taxable years beginning after December 31, 1986, as provided in the 1986 Act, a U.S. branch of a foreign corporation is subject to a branch profits tax in the United States on any deemed repatriation of the branch's U.S. effectively connected earnings and profits. The branch profits tax rate is 30 percent (but can be reduced or eliminated by treaty), and is levied on the branch's dividend equivalent amount. The branch profits tax provision generally replaces the second-level withholding tax (discussed above) which the United States imposed prior to the 1986 Act.

In addition to the branch profits tax, the 1986 Act provides for a 30-percent (or lower treaty rate) tax to be levied on any interest allocable to and deducted by the U.S. branch of a non-U.S. corporation.

Indonesian system for taxing dividends

Indonesia generally assesses a 20-percent withholding tax on the gross amount of Indonesian source dividends paid to a nonresident. In addition, a non-Indonesian corporation that has a permanent establishment in Indonesia is subject to a 20-percent withholding tax on its after-tax profits attributable to the permanent establishment (i.e., a branch profits tax). These withholding tax rates have been reduced in certain tax treaties into which Indonesia has entered.

Proposed treaty rules

Under the proposed treaty, dividends derived from sources within one of the countries by a resident of the other country are taxable by both countries; however, the source-country tax may not exceed 15 percent of the gross amount of the dividend actually distributed.

The limitation contained in the proposed treaty on the rate of withholding tax will not apply if the recipient of the dividend has a permanent establishment or fixed base in the source country and the shares with respect to which the dividend is paid are effectively connected with the permanent establishment or fixed base. In that case, the dividend is taxed as business profits (Article 8) or as income from independent personal services (Article 15), as appropriate. In addition, the reduced withholding tax rate does not apply with respect to U.S. source dividends received by U.S. citizens who are resident in Indonesia (Article 28(3)).

Under the proposed treaty, the country in which a corporate resident of the other country has a permanent establishment is authorized to impose a branch profits tax and a branch-level interest tax in accordance with its internal law on the profits attributable to, or interest payments allocable to, the permanent establishment. The rate of the branch-level taxes generally is not to exceed 15 percent. In computing net profits which are subject to a branch profits tax, any company tax and other income taxes imposed by the source country on the income of the permanent establishment are allowed as a deduction.

The proposed protocol clarifies that the United States' branch-level tax on interest may be imposed on the excess of interest deducted in determining the profits of the permanent establishment over the actual payments of interest by the permanent establishment. Under U.S. law, a permanent establishment is allowed to deduct an allocable portion of the interest expense of its home office. If the deduction exceeds the amount of interest actually paid by the permanent establishment, the excess deduction is treated as if it were remitted to the home office subject to the branch-level interest tax.

In the case of any production-sharing contracts and contracts of work (or any other similar contracts) relating to oil and gas or other mineral products negotiated by the Government of Indonesia, its instrumentality, its relevant State oil company, or any other entity thereof with a person who is a U.S. resident, the rate of branch-level profits or interest taxes is not affected by the provisions of the proposed treaty. In such cases, the Indonesian statutory tax rate of 20 percent applies.

The U.S. model treaty and most recent U.S. income tax treaties define the term "dividends;" the proposed treaty does not. This generally leaves to local law the definition of the term in certain cases.

Article 12. Interest

Subject to numerous exceptions, the United States imposes a 30-percent tax, collected by withholding, on U.S. source interest paid to foreign persons under the same rules that apply to dividends. Interest paid, however, on certain portfolio indebtedness to nonresident alien individuals and foreign corporations and interest on deposit in banks is exempt from U.S. tax. For purposes of the 30-percent tax, U.S. source interest generally is interest on debt obligations of U.S. persons. Excluded from U.S. source interest is interest paid by a U.S. person who satisfies an 80-percent foreign business requirements test over a three-year period. As previously discussed, the United States also imposes a 30-percent branch-level interest tax on interest allocable to a U.S. branch of a non-U.S. corporation.

Indonesia generally imposes a withholding tax of 20 percent on interest paid from Indonesian sources to nonresident persons.

As well as allowing a taxpayer's country of residence to tax interest income, the proposed treaty generally allows the imposition of a withholding tax at source on interest. The proposed treaty limits the rate of tax to 15 percent of the gross amount of the interest, however, in situations where the interest is beneficially owned by a resident of the other country. This 15-percent rate contrasts with the U.S. model position, not generally achieved, that interest should be exempt from tax at source.

In cases where interest is derived from sources within one country by the government of the other country or its agency or instrumentality which is exempt from tax in that country, such interest is exempt from source-country tax under the proposed treaty.

As in the case of dividends, if interest is paid on debt that is effectively connected with a permanent establishment or fixed base in the source country, the interest is taxed as business profits (Article 8) or as income from independent personal services (Article 15), as the case may be. That is, the 15-percent rate limitation and exemptions of this article do not apply. In addition, the reduced withholding tax rate does not apply with respect to U.S. source interest received by U.S. citizens who are resident in Indonesia (Article 28(3)).

The proposed treaty addresses the issue of interest charges between related parties that are not at arm's-length by providing that the amount of interest for purposes of applying this article is the amount of arm's-length interest. Where any amount designated as interest paid by a person to any related person (Article 10) exceeds an amount which would have been paid to an unrelated person, the proposed treaty's interest provisions apply only to so much of the interest as would have been paid to an unrelated person. The excess payment may be taxed by each country according to its own law, including the other provisions of the proposed treaty where applicable. For example, excess interest paid to a parent corporation might be treated as a dividend under local law and thus be entitled to the benefits of Article 11 of the proposed treaty.

The proposed treaty defines "interest" as income from bonds, debentures, government securities, notes, or other evidences of indebtedness, whether or not secured by a mortgage or other securities and whether or not carrying a right to participate in profits, and debt-claims of every kind, as well as all other income which, under the tax law of the country in which the income has its source, is assimilated to income from money lent. This definition is similar to the definition of interest contained in the U.S. model.

Article 13. Royalties

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. Generally, royalties are from U.S. sources if they are for the use of property located in the United States. U.S. source royalties include royalties for the use of, or the right to use, intangible assets in the United States. Such royalties include motion picture royalties.

Indonesia generally imposes a 20-percent withholding tax on Indonesian source royalties paid to nonresident persons.

Under the proposed treaty, royalties derived by a resident of one country from sources within the other country (the "source country") generally are taxable by both the country of residence and the country of source; however, the source-country tax rate may not exceed a rate specified by the proposed treaty. The reduced withholding tax rate does not apply with respect to U.S. source royalties received by U.S. citizens who are resident in Indonesia (Article 28(3)).

The proposed treaty provides that a maximum source-country tax rate of 15 percent applies to payments of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, motion pictures and works on film, videotape or other means of reproduction used for radio or television broadcasting, patents, designs, models, plans, secret processes or formulae, trademarks, or for information concerning industrial, commercial, or scientific experience. Also taxed at a 15-percent rate are gains derived from the sale, exchange, or other disposition of any such property or rights to the extent that the amounts realized on such disposition for consideration are contingent on the productivity, use, or disposition of the property or rights.

A maximum source-country tax rate of 10 percent applies to royalties such as payments by a resident of one country for the use of, or the right to use, industrial, commercial, or scientific equipment, but excluding ships, aircraft, or containers the income from which is exempt from source-country tax under the rules applicable to shipping and air transport (Article 9). Income from the leasing of containers by a leasing company and payments for the leasing of drilling rigs and similar equipment, however, are subject to a 10-percent source-country tax under this article.

As in the case of dividends and interest, if the property or right giving rise to the royalty is effectively connected with a permanent establishment or a fixed base, the royalty is taxed as business profits (Article 8) or as income from independent personal services (Article 15), as appropriate.

As in the case of interest, if a royalty is paid between related persons (Article 10) and exceeds an arm's-length amount, the excess is not treated as a royalty, but may be taxed by each country according to its own law, including the other provisions of the proposed treaty where applicable. For example, excess royalties paid to a parent corporation may be treated as a dividend under local law and thus may be entitled to the benefits of Article 11 of the proposed treaty.

Article 14. Capital Gains

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S.

trade or business or, in the case of a nonresident alien, he or she is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended ("FIRPTA"), a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations holding U.S. real property. In addition, legislation has been introduced in Congress that would tax gains realized by foreign persons on dispositions of stock of U.S. corporations in cases where the foreign person is a substantial shareholder (at least 10 percent) of that corporation.[12]

The proposed treaty generally provides that gains derived by a resident of one country are exempt from tax by the other country. The general exemption does not apply in three situations. In those situations, gains are taxable by both countries (with relief from double taxation provided pursuant to Article 23).

First, a resident of one country who derives gains from the sale, exchange, or other disposition of real property referred to in Article 6 (Income from Immovable (Real) Property) that is situated in the other country is not exempt from tax by the other country with respect to such gains. For purposes of the proposed treaty, a U.S. real property interest (for example, stock in a U.S. real property holding company) is considered situated in the United States and an interest in real property situated in Indonesia is considered situated in Indonesia. In conjunction with Article 15, this provision allows the United States to tax any transaction of a Indonesian resident taxable under section 897 of the Code.

Second, gains on the sale, exchange, or other disposition of property that forms a part of the business property of a permanent establishment or a fixed base (including gains on the disposition of the permanent establishment or the fixed base itself) are not exempt from tax in the country where the permanent establishment or fixed base is located. These gains are taxed in that country as business profits (Article 8) or income from independent personal services (Article 15), as appropriate. Gains, however, are exempt from tax if they are derived by a resident of one of the countries from the deemed alienation of an installation or drilling rig or ship used for the exploration for or exploitation of oil and gas resources which constituted a permanent establishment (under Article 5) in the other country. This rule has the effect of prohibiting either country from imposing an "exit tax" or "balancing charge" on the withdrawal of a drilling rig from its territory by treating that withdrawal as a deemed disposition, subject to tax on the deemed gain.

Third, if the recipient of the gain is an individual who is present in the source country for a period or periods aggregating 120 days or more during the taxable year, then the source country may tax such gain. Notwithstanding the 120-day threshold, the United States generally would not tax gain derived by an individual resident of Indonesia from sources within the United States unless

[12] H.R. 3299, sec. 11404, 101st Cong., 1st Sess. (1989); H.R. 4308, sec. 201, 101st Cong., 2d Sess. (1990); S. 2410, sec. 201, 101st Cong., 2d Sess., (1990).

that individual was present in the United States for at least 183 days during the taxable year pursuant to U.S. internal law.

Gains from the disposition of certain property used in shipping and air transportation operations is covered under Article 9 of the proposed treaty rather than under this article.

Article 15. Independent Personal Services

The United States taxes the income of a nonresident alien individual at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 8 (Business Profits).) The performance of personal services within the United States can be a trade or business within the United States (Code sec. 864(b)).

The proposed treaty limits the right of a country to tax income in respect of professional services or other activities of an independent character by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services is treated separately from salaries, wages, and similar remuneration received by employees.

Under the proposed treaty, income from the performance of independent personal services in one country (the "source country") by an individual resident of the other country is exempt from tax in the source country, unless the individual performing the services (1) has a fixed base regularly available to him or her in that country for the purpose of performing the activities or (2) is present in the source country for 120 days or more during any consecutive 12-month period. In the former case, the source country can tax only that portion of the individual's independent personal services income that is attributable to his or her fixed base in that country. In the latter case, only so much of the income as is derived from activities performed in the source country is taxable by that country. In either case, the country of residence may also tax that income, subject to the proposed treaty's provisions for relief from double taxation (Article 23).

The exemption from tax provided in this article is similar to that provided in the United Nations model treaty between developed and developing countries. The U.S. and OECD model treaties, by contrast, provide a broader tax exemption; they do not contain a 120-day rule but rather allow taxation in the source country only on the basis of a fixed base regularly available there to the individual performing the independent personal services.

For purposes of this article, independent personal services include all personal services performed by an individual for his or her own account if the individual receives the income and bears the losses arising from the services. Independent personal services are not limited to services performed by persons in professions such as physicians, lawyers, engineers, architects, dentists, and accountants, but include independent scientific, literary, artistic, educational, or teaching activities as well.

Article 16. Dependent Personal Services

Under the Code, the income of a nonresident alien individual from the performance of personal services in the United States is not taxed if the individual is in the United States for less than 90 days during a taxable year, the compensation is less than $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or for a foreign office or place of business of a U.S. person.

Under the proposed treaty, income from labor or personal services performed as an employee (including income from services performed by an officer of a corporation or company) in one country (the "source country") by a resident of the other country are not taxable in the source country if three requirements are met: (1) the individual is present in the source country for less than 120 days during any consecutive 12-month period; (2) the employer is not a resident of the source country; and (3) the compensation is not borne or reimbursed (i.e., deducted) by a permanent establishment of the employer in the source country. If these requirements are not all met, the source country may tax the individual's income from dependent personal services. The source-country tax exemption contained in the proposed treaty is similar to that provided in the U.S. model. However, under the U.S. model, the first requirement is that the individual is present in the source country for less than 183 days (rather than 120 days) during a taxable year (rather than during any consecutive 12-month period).

Compensation derived by an employee aboard a ship or aircraft operated by a resident of one country in international traffic is taxable by that country under the proposed treaty. The proposed treaty generally exempts such compensation from tax by the other country, provided that the compensation is in respect of employment as a member of the regular complement of the ship or aircraft. However, under the saving clause (Article 28), such compensation is taxable by that other country if the employee is a resident or citizen of that country. This provision differs from the corresponding provision of the U.S. model treaty, which permits taxation of the compensation only in the country where the employee resides.

Article 17. Artistes and Athletes

The proposed treaty contains a separate set of rules that apply to the taxation of income earned with respect to services performed by public entertainers (such as theater, motion picture, radio, or television "artistes" or musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 15 and 16) and are intended, in part, to prevent entertainers and athletes from using the proposed treaty to avoid paying any tax on their income earned in one of the countries.

Under the proposed treaty, one country (the "source country") may tax entertainers and athletes who are residents of the other country on the income derived from their personal activities performed in that country if their gross receipts (including reimbursed expenses or expenses borne on their behalf) exceed $2,000 or its equivalent in Indonesian rupiahs in any consecutive 12-month period. The comparable annual total in the U.S. model treaty is $20,000 (including reimbursed expenses). Under this provision, for example, if an Indonesian entertainer does not maintain a fixed base in the United States and performs in the United States (as an independent contractor) for one day during a taxable year for total compensation (including reimbursed expenses) of $1,900, the United States can not tax that income. If however, the entertainer's total compensation for that day is $2,100, the full $2,100 (less appropriate deductions) is subject to U.S. tax.

In addition, the proposed treaty provides that if income in respect of personal activities performed by an entertainer or athlete in his or her capacity as such accrues not to the entertainer or athlete, but to another person, that income is taxable by the source country. (This provision applies notwithstanding the articles on business profits and independent personal services (Articles 8, and 15).) This provision is intended to prevent performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or trust located in a country that would not tax the income.

The proposed treaty provides that the rules described above regarding the remuneration of an entertainer or athlete do not apply if the income is derived from a visit to one of the countries that is substantially supported or sponsored by the entertainer's or athlete's country of residence and certified by the competent authority of that country as qualifying for this exception. This rule is intended to remove from the scope of this article cultural exchanges and performances that the governments of the two countries encourage by providing sponsorship or support. In such cases, the taxation of the compensation is governed by the articles of the proposed treaty dealing with personal services (Articles 15 and 16).

Article 18. Governmental Service

The proposed treaty generally exempts wages of employees of one of the countries from tax in the other country. Under the proposed treaty, remuneration paid from public funds of one country to an individual for personal services performed as an employee of that country in the discharge of governmental functions is exempt from tax by the other country. As an exception to this general rule, such remuneration is taxable only in the other country if the services are rendered in that country by a resident of that country who either is a national of that country or did not become a resident there solely for the purpose of performing those services. Thus, for example, Indonesia may not tax the compensation of an individual who is in Indonesia to perform services for the U.S. Government in the discharge of governmental functions unless that individual is a resident and citizen of Indonesia or is a resident of Indonesia and was so resident prior to beginning work for the U.S. Government there. The exception to the general rule does not apply to public pensions paid in respect of past services. Any pension paid out of government funds of one of the countries to an individual in respect of services rendered to that country is taxable only by that country.

The preceding rules pertaining to this article generally are subject to the saving clause (Article 28), except in the case of a person who is not a citizen of or an immigrant in the country conferring benefits to that person under Article 18.

Similar to the corresponding article of the U.S. model, the proposed treaty provides that the exemption for compensation of government employees applies to compensation paid by political subdivisions and local authorities of the countries as well as to compensation paid by the countries themselves.

The proposed treaty clarifies that this article does not apply with respect to payments made in respect of services rendered in connection with a trade or business carried on by one of the countries. In such a case, the provisions of the articles dealing with personal services (Articles 15 and 16) or private pensions and annuities (Article 21) apply, as appropriate.

Article 19. Students and Trainees

The proposed treaty provides special host country tax exemptions for income of a resident of one country who visits the other as a student or trainee. These treaty exemptions are broader than those provided in the U.S model. They are similar to the exemptions incorporated in a number of older U.S. income tax treaties.

Students

Under the proposed treaty, an individual who is a resident of one country immediately before entering the other country (the "host country") solely as a student at a recognized university, college, school, or other recognized educational institution in that country, or as a recipient of a grant, allowance, or award from the government of either country or from a religious, charitable, scientific, or educational organization or under a technical assistance program entered into by the government of either country is eligible for a limited exemption from tax in the host country. The exemption is limited to a period not exceeding five years from the date of the individual's arrival in the host country. The exemption applies only to the amount of such grant, allowance, or award, all remittances from abroad for the purpose of the individual's maintenance, education, study, research, or training, and up to $2,000 (or its equivalent in Indonesian rupiahs) per year of income [13] from personal services performed in the host country, provided that the services are performed in connection with the individual's study, research, or training or are necessary for the purpose of his or her maintenance.

These rules require that the individual must be involved in a full-time program of study, research, or training. Such an individual is allowed, however, to obtain part-time employment or engage in occasional outside activities without forfeiting the benefits provided in this article.

Trainees

Under the proposed treaty, an individual who is a resident of one country immediately before the time he or she becomes temporarily present in the other country solely as a business or technical apprentice is eligible for a limited exemption from tax in the host

[13] Any such income in excess of the $2,000 limit is taxable by the host country. In such a case, the $2,000 exemption does not cause a reduction in any personal exemptions or deductions permitted under the laws of the host country.

country. The exemption applies for a period not exceeding twelve consecutive months, beginning on the individual's date of arrival in the other country, with respect to up to $7,500 (or its equivalent in Indonesian rupiahs) of the individual's income from personal services. Any amount earned in excess of the $7,500 limit is taxable by the host country.

Article 20. Teachers and Researchers

Under the proposed treaty, an individual who is a resident of one of the countries immediately before entering the other country (the "host" country) and who, at the invitation of a university, college, school, or other similar educational institution, is present in the host country solely for the purpose of teaching or research or both at such educational institution is eligible for a limited exemption from tax in the host country. In such a case, the individual is exempt from tax of the host country on any remuneration for such teaching or research for a period not to exceed two years from the date of the individual's arrival in the host country.

The proposed treaty specifies that an individual is only eligible for the benefits provided under this article once. The proposed treaty further provides that this article does not apply to income from research if such research is undertaken primarily for the private benefit of a specific person or persons. In addition, this article only applies to academic or technical programs; it does not apply to recreational courses.

Article 21. Private Pensions and Annuities

Under the proposed treaty, pensions and other similar remuneration paid to an individual resident of one country in consideration of past employment in the other country (the "source" country) is subject to tax by both countries. In such a case, the tax imposed by the source country may not exceed 15 percent of the gross amount of the remuneration. This article does not apply to a pension paid with respect to government service (Article 18 (Government Service)), nor does it apply to social security benefits (Article 22). This rule differs from the rule contained in the U.S. model, which allows only the residence country to tax income from a private pension. The term "pensions and other similar remuneration" means payments made by reason of retirement or death, in consideration for services rendered, or as compensation for injuries received in connection with past employment.

The proposed treaty further provides that annuities are taxable only in the recipient's country of residence. "Annuities" are defined as stated sums paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than for services). A pension received in the form of an annuity is taxed under the proposed treaty as a pension.

In addition, the proposed treaty provides that alimony and child support payments made by a resident of one of the countries to a resident of the other country are exempt from tax in the recipient's country of residence. "Alimony" is defined as periodic payments made pursuant to a divorce decree, separate maintenance agreement, or support or separation agreement.

These rules are not subject to the saving clause. Thus, for example, a country may not tax alimony received by a citizen of that country residing in the other country.

Article 22. Social Security Payments

Social security payments and similar benefits paid out of public funds by one country to a resident of the other country or to a U.S. citizen are taxable only by the paying country under the proposed treaty. This rule, which is not overridden by the saving clause, exempts U.S. citizens and U.S. residents from U.S. tax on Indonesian public pensions and Indonesian residents and U.S. citizens from Indonesian tax on U.S. social security payments. Under this provision, only the United States may tax U.S. social security payments to U.S. persons residing in Indonesia. The rule thus safeguards the United States' right under the Social Security Amendments of 1983 to tax a portion of U.S. social security benefits received by nonresident individuals, while protecting any such individuals residing in Indonesia from double taxation.

Article 23. Relief from Double Taxation

Background

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that is subject to tax in the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on foreign source income only. This limitation generally is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for oil and gas extraction income, passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income.

Foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction). However, no such limitation will be imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met. The 90-percent alternative minimum tax foreign tax credit limitation, enacted in 1986, overrode contrary provisions of then-existing treaties.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation when dividends are received by the U.S. corporation from the foreign corporation (the "indirect foreign tax credit") (Code sec. 902). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of taxes to be credited. However, if the foreign corporation is not a controlled foreign corporation (Code sec. 957), then the dividends received from such corporation, and the foreign taxes attributable thereto, are included in a separate foreign tax credit limitation category.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person is taxable on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double taxation problem is dealt with in other articles that limit the right of a source country to tax income and that coordinate the source rules. This article provides further relief for cases where both Indonesia and the United States will still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence waives its overriding taxing jurisdiction to the extent that the article applies.

The proposed treaty provides separate rules for relief from double taxation for the United States and Indonesia.

United States

Under the proposed treaty, the United States provides its citizens and residents with a foreign tax credit against their U.S. income tax for the appropriate amount of Indonesian tax paid. The credit is computed in accordance with the provisions and subject to the limitations of U.S. law applicable to the year in question.[14] The credit may not exceed the limitations provided by U.S. law for the taxable year. The proposed treaty does not guarantee an indirect foreign tax credit, because Indonesian law does not allow a credit for deemed paid taxes in similar cases.

Indonesia

The proposed treaty requires that, in accordance with and subject to the limitations of Indonesian law for the year in question, Indonesia provide its residents a credit against their Indonesian tax for the appropriate amount of income taxes paid to the United States.

Source rules

For purposes of applying both the U.S. and Indonesian credits under the proposed treaty, the proposed treaty's source rules (Article 7) apply, but in the case of the United States, these rules are subject to such source rules of U.S. law as apply solely for the purposes of limiting the foreign tax credit. Furthermore, each country

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[14] It is understood that, for purposes of the U.S. alternative minimum tax, the foreign tax credit allowable is limited under the proposed treaty to 90 percent of the pre-credit liability for such tax, as provided under U.S. law.

applies its domestic laws for the purpose of determining whether or not a tax is creditable.

The 1984 Act amended the foreign tax credit limitation rules to prevent U.S. persons from treating as foreign source income dividends, interest, and certain other income derived through a foreign corporation a significant part of whose income arose in the United States. As mentioned above, the proposed treaty provides that the United States is required to credit taxes paid to Indonesia only in accordance with the provisions and subject to the limitations of the law of the United States, as in force from time to time. Furthermore, the proposed treaty provides that in applying the United States credit in relation to taxes paid to Indonesia, special treaty source rules apply subject to such source rules in domestic law as apply solely for the purposes of limiting the foreign tax credit. Because the 1984 Act change is a U.S.-law source rule that applies solely for purposes of limiting the foreign tax credit, it is understood that the Treasury Department interprets the proposed treaty not to override the 1984 amendment.

Article 24. Non-Discrimination

The proposed treaty contains a comprehensive non-discrimination article relating to all taxes of every kind imposed at the national level. It is similar to the non-discrimination article in the U.S. model treaty and to provisions that are embodied in other recent U.S. income tax treaties.

Generally under the proposed treaty, one country (the "source country") may not discriminate by imposing more burdensome taxes or related requirements on citizens of the other country (who are resident in the source country) than it imposes on its own resident citizens in similar circumstances.

Generally, the proposed treaty prohibits a source country from imposing less favorable taxes or connected requirements on permanent establishments of residents of the other country than it imposes on its comparable residents carrying on the same activities. However, neither country is required to grant to residents of the other country the personal allowances, reliefs, or deductions for tax purposes on account of personal status or family responsibilities which it grants to its own residents. This rule does not limit a source country's ability to levy a tax on branch-level profits or interest of a permanent establishment of a resident of the other country (Article 11). Nor does it limit a source country's ability to collect a tax owed by residents of the other country by withholding at source since such a procedure is a reasonable mechanism for collecting the tax due from persons not continually present in the source country.

The rule of non-discrimination also applies to corporations of one country that are owned in whole or in part by residents of the other country. A corporation resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, is not to be subjected in its country of residence to any taxation or any connected requirements that are other or more burdensome than the taxation and connected requirements that the corporation's residence country imposes or may impose on its corporations which carry on the same activities and which are owned or controlled by its residents.

Each country is required (subject to the arm's-length pricing rules of Articles 10(1) (Related Persons), 12(5) (Interest), and 13(5) (Royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions (including rules governing allowable debt to equity ratios) that it allows deductions for such amounts paid to residents of the same country as the payor. For purposes of capital taxes, debts that are owed residents of the other country are deductible to the extent that they would be deductible if owed to a resident of the country of residence of the obligor.

The non-discrimination article does not override the right of the United States to tax foreign corporations on their dispositions of U.S. real property interests because the effect of the provisions imposing such tax is not discriminatory. The election to be treated as a U.S. corporation under Code section 897(i) precludes the possibility of discrimination.

The saving clause (which allows the country of residence or citizenship to tax notwithstanding certain treaty provisions) does not apply to the non-discrimination article.

Article 25. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision which authorizes the competent authorities of the United States and Indonesia to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under the proposed treaty, a resident of one country who considers that the actions of one or both of the countries will cause him or her to pay tax not in accordance with the proposed treaty may present the case to the competent authority of the country of his or her residence, or in cases where the non-discrimination article applies (Article 24), an aggrieved person may also present his or her case to the competent authority of the country of which that person is a national (but not a resident). The case must be presented to the competent authority within three years of the initial notification of the action which gave rise to the potential problem, except that if a combination of actions taken by both countries results in taxation not in accordance with the proposed treaty, the three year period begins to run only from the first notification of the most recent action. The competent authority then determines whether the claim has merit. If it determines that the claim does have merit, the competent authority will endeavor to seek a solution independently or come to an agreement with the competent authority of the other country with a view to the avoidance of taxation that is contrary to the provisions of the proposed treaty.

The competent authorities may also consult together for the elimination of double taxation in cases not provided for in the proposed treaty. For example, the competent authorities of the two countries may mutually agree upon a common definition of a term used in the proposed treaty or to a characterization of a particular item of income.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. When it seems advisable for the purpose of reaching an agreement, they may meet for an oral exchange of opinions. These provisions clarify that it is not necessary to go through normal diplomatic channels in order to discuss problems arising in the application of the proposed treaty. They also remove any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Indonesia.

In the event that the competent authorities reach an agreement under this mutual agreement article, taxes are imposed, and a refund or credit of taxes is allowed by the countries in accordance with that agreement. This article provides for the waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations. However, this article does not authorize the imposition of additional taxes after the statute of limitations has run.

Article 26. Exchange of Information

Article 26 forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to obtain information so that they can properly administer the proposed treaty. It is similar to the corresponding article of the U.S. model treaty but differs from the U.S. model in certain respects.

The proposed treaty provides for the exchange of information that is pertinent to carrying out the provisions of the proposed treaty or the provisions of the domestic laws of the two countries concerning taxes to which the proposed treaty applies. The exchange of information rules apply to all national taxes imposed by either country, whether or not otherwise covered by the proposed treaty (Article 2). Thus, for example, the exchange of information provisions apply with respect to estate, inheritance, employment, excise, and sales taxes imposed on a national level by either country.

Similar to the U.S. model, the proposed treaty provides that third-country residents are covered by the exchange of information rules.

Any information exchanged under this article is to be treated as secret in the same manner as information obtained under the domestic laws of the country which receives the information. Exchanged information may be disclosed only to persons (including courts and administrative bodies) concerned with the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed treaty applies. The proposed treaty further provides that such persons may use the information only for the purposes specified in the proposed treaty. In addition, however, they may disclose the information in public court proceedings or judicial decisions. Persons concerned with the administration of taxes include legislative bodies involved in oversight of the administration of taxes, including their agents such as, for example, the U.S. General Accounting Office, with respect to such information as they consider to be necessary to carry out their oversight responsibilities.

The proposed treaty contains limitations on the obligations of the countries to supply information. A country is not required to carry out administrative measures at variance with its laws and administrative practice or to supply information which is not obtainable under its laws or in the normal course of its administration. Moreover, a country is not required to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Upon an appropriate request for information by one country, the requested country is to obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. A requested country is to use its subpoena or summons powers or any other powers that it has under its internal laws to collect information requested by the other country. It is intended that the requested country may use those powers even if the requesting country could not under its internal laws. Thus, it is not intended that this provision be strictly reciprocal. For example, once the Internal Revenue Service has referred a case to the Justice Department for possible criminal prosecution, the U.S. investigators can no longer use an administrative summons to obtain information. If, however, Indonesia could still use an administrative summons to obtain requested information, it would be expected to do so even though the United States could not. The United States could not, however, tell Indonesia which of its procedures to use.

If specifically requested by the competent authority of one country, the competent authority of the other country is to provide the information in the form requested. Specifically, the competent authority of the other country is to provide depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings) to the extent that they can be obtained under its laws and practices in the enforcement of its domestic tax laws.

The proposed treaty specifies that the exchange of information may be either on a routine basis or on request with reference to particular cases. It also specifies that the competent authorities of the two countries may agree on the information to be furnished on a routine basis.

The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of the publication by its respective country of any material concerning the application of the proposed treaty, including legislation, regulations, rulings, or judicial decisions. Notification is to be made by transmitting in the ensuing calendar year the text of any such materials adopted in the course of any given calendar year. Similar notification rules are contained in the article of the U.S. model treaty that sets forth the taxes covered by that treaty.

ↄrticle 27. Diplomatic and Consular Officials

The proposed treaty contains the usual provision stating that it s not to affect the fiscal privileges of diplomatic and consular offi- ials under the general rules of international law or the provisions f special agreements. This provision is intended to make clear that he proposed treaty will not defeat any exemption from tax that a ost country may otherwise grant unilaterally or by agreement to he salaries of diplomatic officials of the other country.

Like the corresponding provision found in the U.S. model and nost U.S. treaties, this provision is fully subject to the saving lause.

rticle 28. General Rules of Taxation

In general

The proposed treaty provides that a resident of one of the coun- ries may be taxed by the other country on any income from ources within that other country, and only on such income, sub- ect to any limitations set forth in the proposed treaty. For this urpose, the rules set forth in Article 7 (Source of Income) are to e applied to determine the source of the income. The proposed reaty contains detailed rules for the taxation of most types of ncome, which generally limit taxation at source, so this general rovision does not determine taxing jurisdiction in most cases. Nev- rtheless, it does differ from the corresponding provisions of the J.S. and OECD model treaties, which generally provide that ncome not otherwise dealt with in the proposed treaty is taxable nly by the country of residence.

The proposed treaty also contains the rule found in other U.S. ax treaties that its provisions do not restrict in any manner any xclusion, exemption, deduction, credit, or other allowance other- ise accorded by the domestic laws of either country or any other greement between the two countries. Thus, the proposed treaty pplies only where it benefits taxpayers. In cases where a treaty rovision would have a detrimental effect on a taxpayer, the tax- ayer may elect to utilize the rules of domestic law or of another greement between the two countries.

This article also provides that the competent authorities of the wo countries may each prescribe regulations necessary to carry ut the provisions of the proposed treaty.

Saving clause

Like all U.S. income tax treaties, the proposed treaty contains a saving clause." Under this clause, with exceptions described elow, the United States reserves the right to tax its citizens and esidents and Indonesia reserves the right to tax its citizens and esidents, notwithstanding any provision of the proposed treaty. By eason of the saving clause, the United States generally continues tax its citizens who are residents of Indonesia as if the proposed eaty were not in force. "Residents," for purposes of the proposed eaty (and thus for purposes of the saving clause), include corpora- ons and other entities as well as individuals (Article 4 (Fiscal Res- lence)). Under Code section 877, a former U.S. citizen whose loss citizenship had as one of its principal purposes the avoidance of

U.S. income, estate, or gift taxes, is, in certain cases, subject to U.S. tax for a period of 10 years following the loss of citizenship. The proposed treaty contains the standard provision found in the U.S. model and most recent treaties specifically reserving the United States' right to tax such former citizens. (Even absent a specific provision the Internal Revenue Service has taken the position that the United States retains the right to tax former citizens resident in the treaty partner (Rev. Rul. 79-152, 1979-1 C.B. 237).)

Exceptions to the saving clause are provided for the benefits conferred by the articles dealing with adjustments to be made by one country in accordance with adjustments made by the other country in the case of certain transactions between related persons (Article 10(3)), the exemption from tax in the country of residence of certain alimony and child support payments (Article 21(3)), social security payments (Article 22), relief from double taxation (Article 23), non-discrimination (Article 24), and mutual agreement procedures (Article 25). The benefits of those articles are conferred by each country on its own citizens and residents as well as the citizens and residents of the other country. In addition, the benefits conferred by the articles dealing with the taxation of income received by government employees (Article 18), students and trainees (Article 19), teachers and researchers (Article 20), and diplomatic and consular officers (Article 27) are provided by each country to its residents who are neither citizens of, nor have immigrant status in, that country. A person has "immigrant status" in the United States if he or she has been admitted to the United States as a permanent resident under U.S. immigration laws (that is, he or she holds a "green card").

Other than under the foregoing exceptions to the saving clause, U.S. citizens and residents benefit under the proposed treaty only as the result of the agreement by Indonesia to reduce its rate of tax on their income or exempt their income from tax; they do not benefit under the proposed treaty from reductions in tax or tax exemptions granted by the United States. Similarly, except as noted above, Indonesian citizens and residents benefit under the proposed treaty only as the result of the agreement by the United States to reduce its rate of tax on their income or exempt their income from tax.

Limitation on benefits

Finally, this article contains rules to prevent "treaty-shopping" by persons not intended to benefit from the proposed treaty. Generally, a resident of one of the countries (other than an individual) is not entitled to relief from tax in the other country under the proposed treaty unless (1) more than 50 percent of the beneficial interest in such resident is owned, directly or indirectly, by any combination of individuals who are citizens or residents of the United States or residents of Indonesia, a company whose principal class of shares is substantially and regularly traded on a recognized stock exchange (e.g., the NASDAQ System, any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934, the Jakarta stock exchange, and any other exchange agreed upon by the competent authorities of the two countries), and the overnments of either of the two countries, and (2) the income of ıch person is not used in substantial part, directly or indirectly, to ıeet liabilities (including deductible expenses such as interest and ɔyalty payments) to persons other than those listed above. The urpose of the second requirement, generally referred to as a "base rosion" rule, is to prevent residents of third countries from utilizıg a company resident in either the United States or Indonesia hich meets the ownership requirements (discussed above), but hich pays out a substantial portion of its income to such third ountry residents in the form of deductible expenses.[15] In deterıining whether a company meets the 50-percent beneficial ownerıip test, more than 50 percent of the number of shares of each ass of its stock must be beneficially owned by the persons speciied in the preceding sentence.

The treaty-shopping rules described above do not apply to an ntity, the establishment, acquisition, and maintenance of which, nd the conduct of whose operations did not have as a principal urpose the purpose of obtaining benefits under the proposed eaty.

rticle 29. Assistance in Collection

This article of the proposed treaty requires that each country aid ı collecting the taxes of the other country to the extent necessary) insure that exemptions from tax and reduced rates of tax grant- under the proposed treaty by that other country are not enjoyed y persons not entitled to those benefits. In doing so, the competent ıthorities of the two countries may consult together. A country is ot obligated by this article to carry out administrative measures : variance with its regulations and practices with respect to the ollection of its own taxes.

The rules of this article are similar to rules found in the U.S. ıodel treaty. The U.S. model rules are included in its exchange of ıformation article.

rticle 30. Entry into Force

The proposed treaty is to be ratified and instruments of ratificaon exchanged in Washington, D.C. as soon as possible. The proɔsed treaty will enter into force one month after the exchange of ıe instruments of ratification. It takes effect with respect to taxes ithheld at source in accordance with the articles on dividends, inrest, and royalties (Articles 11, 12, and 13) for amounts paid or edited on or after the first day of the second month next followg the date on which the proposed treaty enters into force. With spect to other taxes, the proposed treaty takes effect for calendar taxable years beginning on or after the January 1st of the year which it enters into force.

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[15] This base erosion rule is not intended to disallow treaty benefits to companies resident in her of the treaty countries that, for business reasons, purchase supplies from third country idents. The rule applies only with respect to deductible expenses paid by the company to such rsons, not to cost of goods sold.

Article 31. Termination

The proposed treaty is to remain in force indefinitely, but eithe country may terminate it at any time after five years from it entry into force by giving at least six months' prior notice throug diplomatic channels. If a termination occurs, it is effective with re spect to income of calendar or taxable years beginning (or, in th case of taxes payable at the source, payments made) on or after th January 1st next following the expiration of the six-month perioc

Exchange of Letters

In letters exchanged when the proposed treaty was signed, th countries confirmed their agreement under Article 3(1)(a) of th proposed treaty (General Definitions) that the United States recog nizes the archipelagic States principles as applied by Indonesia o the understanding that they are applied in accordance with th provisions of Part IV of the 1982 United Nations Convention on th Law of the Sea and that Indonesia respects international right and obligations pertaining to the transit of the Indonesian archipe lagic waters in accordance with the international law as reflecte in that Part.