[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND INDONESIA

TO BE CONSIDERED

BY THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

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, describes the proposed protocol to the income tax treaty between the United States and Indonesia. The proposed protocol was signed on July 24, 1996.[2] The proposed protocol amends the Convention Between the Government of the United States of America and the Government of the Republic of Indonesia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Resect to Taxes on Income, with a related protocol and exchange of notes (the "Convention"). The Convention was signed on July 11, 1988 and entered into force on December 30, 1990. The Senate Committee on Foreign Relations will consider the proposed protocol at its next Committee business meeting.

Part I of the pamphlet provides a summary with respect to the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains an explanation of the proposed protocol. Part IV contains a discussion of the issues with respect to the proposed protocol.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Indonesia* (JCS–8–96), September 16, 1996.

[2] For a copy of the proposed protocol, see Senate Treaty Doc. 104–32, September 4, 1996.

I. SUMMARY

The principal purposes of the Convention are to reduce or eliminate double taxation of income earned by 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 Convention contains a number of developing country concessions. In particular, the Convention provides maximum rates of source country tax on certain dividends, interest and royalties that exceed the rates preferred by the United States. The proposed protocol reduces those maximum rates of source country tax.

The Convention (as modified by the proposed protocol) is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty ("U.S. model"),[3] and the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model"). However, the Convention as so modified contains certain substantive deviations from those documents.

[3] The Treasury Department has withdrawn the U.S. model from use as a model treaty. Accordingly, its provisions may no longer represent the preferred position for U.S. treaty negotiations. However, the Treasury Department has not yet released a new model. Pending the release of a new model, comparison of the provisions of the Convention as amended by the proposed protocol against the provisions of the U.S. model should be considered in the context of the provisions of comparable recent U.S. treaties with other countries.

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

A. U.S. Tax Rules

The United States taxes U.S. citizens, residents, and corporations on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations on all their income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation is subject to U.S. tax at a rate of 1 or 4 percent of the premiums. These taxes generally are collected by means of withholding.

Certain statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, 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 tax-

able year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid 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 liability 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 basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

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 (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year the dividend is received.

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by 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. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law 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 partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit,

in 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 agreed to by the source country in treaties are premised on the assumption that the country of residence will tax the income at levels comparable to those imposed by the source country on its residents. 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 addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both the countries. Treaties generally 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 permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums, (e.g., presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on such income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) 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. The United States also provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various 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 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 that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. 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 countries is enhanced further under 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.

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 it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country 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.

III. EXPLANATION OF PROPOSED PROTOCOL

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

Article 1

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

Internal taxation rules

United States

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

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

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

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

lowed with respect to the U.S. business over the interest paid by such business is treated as if paid by a U.S. corporation to a foreign parent and therefore is subject to the 30-percent withholding tax.

Indonesia

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

Convention rules

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

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

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

Proposed protocol rules

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

The proposed protocol reduces the rate of source country tax that may be imposed on the profits attributable to a permanent establishment and on interest payments allocable to a permanent estab-

lishment from 15 percent to 10 percent. This reduced rate of 10 percent applies to both the U.S. and Indonesian branch taxes.

Article 2

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

Internal taxation rules

United States

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

Indonesia

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

Convention rules

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

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

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

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

The Convention defines the term "interest" as income from bonds, debentures, government securities, notes, or other evidences

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

Proposed protocol rules

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

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

Article 3

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

Internal taxation rules

United States

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

Indonesia

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

Convention rules

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

Under the Convention, the rate of source country tax generally is limited to 15 percent of the gross amount of royalties if the beneficial owner of the royalties is a resident of the other country. For purposes of this 15-percent maximum rate, the term "royalties" means payment of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works (including copyrights of motion pictures and films, tapes or other means of reproduction used for radio or television broadcasting), patents, designs, models, plans, secret formulas or processes, and trademarks. It also includes payment for the use of, or the right to use, information concerning industrial, commercial or sci-

entific experience. In addition, the term includes gain derived from the sale, exchange, or other disposition of any such property or rights to the extent that the amounts realized on such sale, exchange or other disposition are contingent on the productivity, use, or disposition of such property or rights.

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

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

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

Proposed protocol rules

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

Article 4

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

Article 5

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

IV. ISSUES

The Convention contains a number of developing country concessions, some of which are found in other U.S. income tax treaties with developing countries. The proposed protocol would modify several of the most significant of these concessions.

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

The Convention contains a number of additional developing country concessions that are not modified by the proposed protocol. These concessions include an expanded definition of permanent establishment; a force of attraction rule with respect to business profits; broader source country taxation of personal services income, capital gains of individuals, private pensions, entertainer's income and other income not specifically covered in the Convention; and the treatment of certain equipment leasing income as royalty income which may be taxed in the source country at a maximum rate of 10 percent.[4]

Developing country concessions raise the issue of the appropriateness of such concessions in general and with respect to the particular treaty partner. There is a risk that the inclusion of these concessions in a treaty could result in additional pressure on the United States to include such concessions in future treaties negotiated with developing countries. The prompt reduction or elimination of developing country concessions contained in a treaty through a subsequent agreement with the treaty partner may help to mitigate such risk.

The Committee may view the proposed protocol's reduction of the maximum rates of source country tax on dividends, interest and royalties under the Convention as a significant move to bring the Convention more in line with general U.S. treaty policy, notwithstanding the fact that the proposed protocol does not eliminate the developing country concessions contained in the Convention.

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