KPMG

Tax Alert

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The New Tax Treaty between Singapore and Indonesia:

Capital Gains Protection included at last!

On 4 February 2020, Singapore and Indonesia signed an updated Avoidance of Double Taxation Agreement (treaty). The new treaty will enter into force after it has been ratified by both countries, with the earliest possible date of effect being 1 January 2021 if ratified by both countries during the course of the year 2020.

Many of the existing treaty provisions continue, including the withholding tax (WHT) rates on dividend and interest income, which remain 10% to15% for dividends and 10% for interest. It is somewhat disappointing that there was no reduction in the dividend WHT rate of 10% for substantial shareholdings to match the Hong Kong – Indonesia tax treaty. Nevertheless, there are some positive changes which are set out below.

1. Introduction of a Capital Gains Article – Including Protection from Indonesian Tax on Sales of Indonesian Shares and Bonds

The existing treaty doesn't have a capital gains article and hence does not restrict Indonesia's ability to impose taxes on Singaporean sellers of Indonesian assets, including shares and bonds. This has long been a disadvantage of the Singapore – Indonesia tax treaty when compared to other Indonesian tax treaties, particularly as Indonesian domestic law imposes a 5% WHT on gross proceeds for the sale of unlisted shares sold by Singapore tax residents.

The new treaty has addressed this issue by including a capital gains article (Article 13), which grants Singapore the sole taxing right on gains from the sale of assets and shares, other than gains from the sale of:

- immovable property, or shares in majority owned unlisted land-rich companies (other than where the immovable property is used in the business of the Indonesian company and / or the transfer occurs as part of a group re-organization);
- moveable property forming part of the business property of a permanent establishment; and
- Indonesian listed shares.

As a result, under the new treaty sales of shares in Indonesian private limited companies and Indonesian bonds by Singapore tax resident sellers should be taxable in Singapore only (so the 5% Indonesia WHT on sale of shares should no longer apply).

The introduction of this article has long been called for and further enhances Singapore's attractiveness as a jurisdiction from which to invest into Indonesia.

2. Reduction in Royalty WHT Rate from 15% to 10% / 8%

Indonesia imposes a 20% WHT under domestic law on payments of royalties to non-residents. Under the existing treaty this rate is reduced to 15% regardless of the type of royalty. Under the new treaty, the rate of WHT has been reduced to:

- 10% on payments for the use of, or right to use, copyright, any patent, trademark, design or model, plan, secret formula or process; and
- 8% for the use of, right to use, industrial, commercial or scientific equipment or knowledge.

The reduction in royalty WHT rate is certainly a positive development for Singapore businesses seeking to license IP or lease equipment into Indonesia. That said, at 8% the WHT rate on equipment lease payments still remains prohibitively high for the lessors of aircraft and ships to Indonesia.

3. Interest on Government Bonds – Removal of Treaty Exemption

Under the current treaty, interest paid on government bonds or debentures are not subject to WHT in the source country. Under the new treaty, this exemption is discontinued, so that the source country may impose up to 10% WHT on such income, as on any other interest income.

While this will not affect Indonesian Government bonds that are issued offshore, as these already enjoy an exemption from interest WHT under Indonesian domestic law, it will impact Indonesian Government bonds that are issued in Indonesia; hence, Singapore investors should take note of the potential for increased interest WHT on their Indonesian bond investments when the new treaty takes effect.

4. Branch Profit Tax Rate reduced from 15% to 10%

Indonesia imposes a 20% WHT rate on the after-tax distributions of Indonesian permanent establishments. The treaty rate has been reduced from 15% to 10%. Note, however that the branches of Indonesian upstream production sharing contracts and mining contracts of work are specifically excluded from this rate reduction.

5. Removal of Limitation of Relief to Remitted Income

Under the existing treaty, treaty benefits are granted to a Singapore resident only in respect of income that is remitted to or received in Singapore. The new treaty does not include a similar limitation of relief provision. Considering that Singapore only taxes certain foreign source income (e.g. interest income) upon remittance into Singapore, the removal of the requirement to remit into Singapore in order to enjoy the treaty rate is a positive change.

6. Introduction of the Principal Purpose Test

The new treaty adopts the Principal Purpose Test (PPT), according to which a treaty benefit shall not be granted if obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted in that benefit. As Indonesia ratified the MLI on 12 November 2019 (but has not yet deposited its instrument of ratification with the OECD), the PPT may become applicable to the current treaty between Singapore and Indonesia even before the new treaty enters into force.

However, Indonesia has already long applied an effective PPT, along with a number of substance and beneficial ownership tests, through its requirement that foreign claimants of treaty benefits complete the Form DGT. Hence, this change should not lead to a significant burden for investors who have invested in Indonesia through Singapore due to valid commercial reasons.

7. Exchange of Information

The new treaty expands the exchange of information between Singapore and Indonesia in several ways. The expanded exchange of information provision will become effective for requests made on or after the entry of the new treaty into force.

KPMG observations

This Tax Alert only seeks to highlight some of the key changes, while further issues and interpretations may be identified going forward.

In general, the new treaty will make Singapore an even more attractive base for investing into Indonesia, among others, for the following reasons:

1. Investors from Singapore will benefit from tax exemption on capital gains arising in Indonesia from the sale of movable property and shares, under the conditions specified above;
2. Royalty WHT rate will be reduced; and
3. Treaty relief will no longer be limited to income remitted to Singapore.

However, some amendments may adversely affect the tax position of specific taxpayers.

We welcome the opportunity to assist you in assessing the impact of the new treaty and tax laws on your structure and operations, including opportunities arising from the changes.

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