Capital Gains, Branch Profits, Royalties: Updates to the Singapore-Indonesia Double Taxation Agreement

Introduction

On 23 July 2021, the Agreement between the Government of the Republic of Singapore and the Government of the Republic of Indonesia for the Elimination of Double Taxation with respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance ("**Updated DTA**") entered into force, following Indonesia's ratification of the Updated DTA on 11 May 2021.

In its official statement, Indonesia's Directorate General of Tax stated that the Updated DTA is meant to strengthen efforts to prevent tax evasion, protect and increase Indonesia's tax base, and at the same time encourage increased investment from Singapore. Similarly, Singapore's Ministry of Finance stated in its press release of 23 July 2021 that the Updated DTA would boost bilateral trade and investment flows between the two countries.

We examine some of the key changes arising from the Updated DTA below, including:

1. The new Article 13 on capital gains;
2. A reduction in branch profit tax;
3. A reduction in royalties tax;
4. Removal of exemption for interest paid on government bonds or debentures;
5. Abolishment of articles on income not expressly mentioned and limitation of relief;
6. Expanded exchange of information provisions; and
7. Application of the principal purpose test.

Notable Changes

1. **New article on capital gains**

   The spotlight is on capital gains as the Updated DTA introduces a standalone capital gains article that adopts the OECD Tax Convention Model. Previously, capital gains were not regulated despite the popularity of Singapore being used by investors as a base from which to invest in Indonesia.

   Indeed, many companies in Indonesia have a Singapore holding company, and a common scenario is the sale by that holding company of its shares in the Indonesian subsidiary. Currently, the Singapore shareholder would face a 5% withholding tax on the gross transfer value of unlisted shares. This 5% rate is the same rate imposed by Indonesia on holding companies from tax haven countries.

Taking the share transfer example above, under the Updated DTA, capital gains received by the Singapore shareholder will be relieved of the 5% withholding tax, except if the sale involves shares in an Indonesian company where more than 50% of that company's value is derived from its immovable property ***and*** the selling shareholder owns more than 50% shares in such company ***and***:

(i) the shares are not traded in a stock exchange;
(ii) the sale was not conducted as a corporate reorganisation, merger, spin-off, or other similar restructuring; and
(iii) the shares do not derive value from the immovable property in which the company's business is conducted.

Compared to the Malaysia-Indonesia tax treaty, which only requires the Indonesian company to satisfy the criteria of having more than 50% (principally, to be exact) of its value derived from its immovable property, the Updated DTA has a more restrictive requirement.

Meanwhile, gains derived from the sales of ships or aircraft or moveable property pertaining to the operation of such ships or aircraft will be taxable only in the state where the selling entity resides.

2. **Reduced branch profit tax ("BPT")**

In the original DTA, BPT was set at 15%. Now, the BPT provisions have been reformulated to become part of the provisions on dividends under Article 10(6) of the Updated DTA and prescribe a lower rate of 10%.

However, it is important to note that the new BPT rate does not apply to certain contracts as set out in Article 10(7). Examples include production sharing contracts relating to oil and gas, and contracts of works for other mining sectors, where such contracts are concluded by a Contracting State (or its relevant state oil and gas company or any other entity thereof) with a person who is a resident of the other Contracting State. Additionally, the Updated DTA also erases the tax treatment provisions on Most Favoured Nation (MFN) towards Singaporean companies.

3. **Reduced royalties tax**

Previously, royalty payments received a flat tax rate of 15%. The Updated DTA allows the 15% tax rate to be reduced as follows:

(i) 10% tax on the gross amount of payments received for the use or the right to use any copyright pertaining to literary, artistic, or scientific work including cinematography film or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process; and

(ii) 8% tax on the gross amount of payments received for the use or the right to use any industrial, commercial, or scientific equipment, or information concerning industrial, commercial or scientific experience.

4. **Removal of exemption for interest paid on government bonds or debentures**

Previously, Article 11(3) of the original DTA provided an exemption for interest paid in respect of government bonds or debentures to a resident of the other Contracting State. Article 11(3) has now been removed, resulting in the "source" state now being able to tax that income but subject to a cap of 10% imposed by Article 11(2).

Another change in Article 11 is the continued exemption of government institutions from being taxed in respect of interest derived from the other Contracting State, but now with an expanded list of government institutions and including their wholly-owned (whether directly or indirectly) subsidiaries. This exemption also applies to sovereign wealth funds like GIC Private Limited and the newly established Indonesia Investment Authority, as well as their subsidiaries.

Additionally, the list for Indonesian government institutions includes the Indonesia Eximbank, Social Security Agency for Health (*Badan Penyelenggara Jaminan Sosial Kesehatan*) and Social Security Agency for Manpower (*Badan Penyelenggara Jaminan Sosial Ketenagakerjaan)*, and any special-purpose investment entity established by the government (like the abovementioned sovereign wealth funds).

The Updated DTA also specifies that any penalty charges for late payments will not be regarded as interest for the purpose of Article 11.

5. **Abolishment of Articles on income not expressly mentioned, limitation of relief**

The Updated DTA abolishes Articles 21 and 22 of the original DTA, which respectively dealt with:

(i) Income that was not expressly mentioned in the DTA. Such income would be governed by the tax laws of the Contracting States.
(ii) The limitation of relief for remitted income. Benefits under the DTA would be applicable only to income remitted to or received in the other Contracting State.

These Articles were replaced with Article 22 on "Other Income" which generally stipulates that income not dealt with in the Updated DTA will be taxable only in the jurisdiction of residence, subject to certain exceptions.

6. **Expanded Exchange of Information ("EOI") provisions**

The Updated DTA also broadens the provisions on EOI by adopting the OECD Model 2017. Now, any request for EOI by one Contracting State must be accommodated even if the requested information is not relevant for the domestic tax purposes of the second Contracting State. Further, the latter may not refuse to supply information solely because the information is held by a bank, other financial institution, nominee, or a person acting in an agency or a fiduciary capacity or ownership interest.

7. **Application of principal purpose test**

Lastly, the Updated DTA introduces a new anti-tax avoidance article under Article 28. Under this Article, benefits of the Updated DTA will not be granted if one of the principal purposes of an arrangement or transaction is to obtain (whether directly or indirectly) the benefits under the Updated DTA.

This is in line with the stance adopted by Indonesia under Presidential Regulation No. 77 of 2019 on the Paris Multilateral Convention. The Convention contains similar provisions by way of the principal purpose test, which is the method to assess the possibility of treaty abuse, including through treaty shopping.

Concluding Remarks

Having been ratified by both Indonesia and Singapore, the Updated DTA has entered into force as of 23 July 2021 and will be effective from 1 January 2022.

We expect the Updated DTA to invigorate and deepen the flow of investments between Singapore and Indonesia. Investors are likely to view this development positively. Singapore shareholders of Indonesian private companies will benefit from the new capital gains tax exemption for the sale of shares. The reduced rate on BPT and royalties are likewise welcome, especially for private equity houses and multinational corporations that depend heavily on their intellectual properties. Moreover, the law finally adopts a standalone capital gains tax provision and clarifies other points, including on interest, which will give more certainty in implementation.

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