Hong Kong-Indonesia Double Tax Agreement: Excellent tax benefits for many

The Hong Kong Special Administrative Region of the People’s Republic of China and the Republic of Indonesia signed a comprehensive agreement for the avoidance of double taxation (CDTA) on 23 March 2010 (HK-Indo CDTA), paving the way for closer knit economic cooperation and trade relations between the two jurisdictions.

Indonesia, a populous country rich in natural resources, is an emerging market with immense investment potential for investors. The HK-Indo CDTA contains many attractive tax benefits, some of which are, by far, the most favorable among Indonesia’s tax treaties, including those with China, the Netherlands and Singapore. With its competitive withholding tax rates and provisions allowing for greater tax certainty, the HK-Indo CDTA will benefit existing and new investors alike.

This article highlights the key features of the HK-Indo CDTA, as well as some of the ways investors in Hong Kong and Indonesia may avail of its tax benefits.

| Comparison of HK-Indo CDTA, Indonesia’s CDTAs with China, the Netherlands and Singapore and domestic withholding tax rates in Hong Kong and Indonesia (as a %) |
|-----------------------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
|                                              | Indonesia Domestic rate¹ | Hong Kong domestic rate | HK-Indonesia CDTA | Indonesia-China CDTA | Indonesia-Netherlands CDTA | Indonesia-Singapore CDTA |
| Dividends                                    | 20               | 0                | 5/10²             | 10              | 10              | 10/15³         |
| Interest                                     | 20               | 0                | 0/10⁴             | 0/10⁴           | 0/10⁴           | 0/10⁴         |
| Royalties                                    | 20               | 4.95⁵            | 5                 | 10              | 10              | 15             |
| Capital gains on disposal of shares in Indonesian company | 5                | 0                | 0/5⁶              | 0/5⁷            | 0               | 5⁸             |

¹ For purposes of this article, only the rates applicable to payments made by Indonesian resident companies to nonresidents are stated. Rates for payments made to residents may differ.

² The 5% rate applies where the beneficial owner is a company that holds directly at least 25% of the capital of the distributing company; otherwise, the rate is 10%.

³ The 10% rate applies where the beneficial owner is a company that owns at least 25% of the capital of the distributing company; the rate is 15% in all other cases.

⁴ Interest received by a government institution is exempt from tax; the 10% rate applies in all other cases. In the case of the Indonesia-Netherlands treaty, interest on loans made for a period of more than two years or interest paid in connection with the sale on credit of industrial, commercial or scientific equipment will not be taxable.

⁵ The 4.95% rate applies provided a) the royalty is not paid to a related party, or b) if paid to a related party, the licensed intellectual property has never been owned in whole or in part by a person carrying on business in Hong Kong.

⁶ Capital gains from the alienation of shares in an Indonesian company are subject to tax in Indonesia at 5% of the sales price if the company derives more than 50% of its asset value directly or indirectly from immovable property situated in Indonesia, and such shares are either a) not transferred as part of a corporate reorganization, or b) the immovable property in question is not property in which the company carries on its business. Capital gains are exempt from tax in all other cases.

⁷ Capital gains from the alienation of shares in an Indonesian company with property that consists directly or indirectly principally of immovable property in Indonesia will be subject to tax in Indonesia at 5%. Capital gains are exempt from tax in all other cases.

⁸ Capital gains from the alienation of shares in all Indonesian companies are subject to tax in Indonesia at 5% of the sales price.

Main features of HK-Indo CDTA and opportunities

An important factor that makes Hong Kong one of Asia’s business destinations of choice is its relatively simple domestic tax regime. Coupled with the favorable withholding tax rates under the HK-Indo CDTA, Hong Kong would be an ideal gateway for investors looking to invest in Indonesia. Indonesian investors with outbound investments in China may also benefit from Hong Kong’s rapidly expanding CDTA network, which boasts one of the most favorable double tax arrangement/agreements concluded by China.
We highlight below the key features of the HK-Indo CDTA and explore some potential tax planning ideas:

**Hong Kong as a regional service centre** – The HK-Indo CDTA increases the threshold for a service permanent establishment (PE) to arise and narrows the scope of the attribution of profits of a PE under Indonesian domestic tax law. This will provide a favorable tax framework for Hong Kong to establish itself as a prime regional service center.

Under Indonesian domestic tax law, a PE will arise where a nonresident providing services in Indonesia remains in the country for more than 60 days in a 12-month period. In that case, the PE will be subject to tax at 25% on income attributable to its services and other income derived by the overseas head office in Indonesia from activities similar in nature to those performed by the PE. In addition, a branch profits tax of 20% will be charged on the PE’s after-tax remittances to its overseas head office.

The HK-Indo CDTA provides for a comparatively higher 183-day threshold to trigger a PE, thereby narrowing the definition that could apply to a Hong Kong service company. Even if a PE were to be triggered in Indonesia, the HK-Indo CDTA would limit the profits attributable to the PE to profits derived from its actual activities, while capping the branch profits tax rate at 5%, provided the Hong Kong company is not established merely to enjoy tax treaty benefits according to Indonesia’s domestic tax regulations. Further, under Hong Kong’s territorial basis of taxation, the income received by the Hong Kong company from services rendered in Indonesia, as well as services rendered outside Hong Kong and Indonesia, would be considered as offshore sourced and not subject to Hong Kong Profits Tax.

Taking all of the above into account, the HK-Indo CDTA should result in significant tax savings for Hong Kong service companies operating in Indonesia.

**Hong Kong as a turnkey solutions hub** – Many companies in the telecommunications and information technology industries typically deliver goods and services under turnkey projects (i.e. a project that is constructed by a developer and sold or turned over to a buyer in a ready-to-use condition). However, the tax treatment of profits from turnkey projects in Indonesia under its domestic tax laws may be onerous; the entire profit from the project will be assessed to Indonesian income tax, even if all of the services under the contract were rendered offshore, and the supplies and equipment for the project were organized entirely from outside Indonesia.

The HK-Indo CDTA offers an attractive platform for turnkey solutions firms looking to access the Indonesian market, in that only profits attributable to the part of a turnkey contract that is carried out by a PE of a nonresident in Indonesia will be subject to income tax. This provision exists only in a few of Indonesia’s CDTAs, such as those with Australia, Austria, France, Germany and the Netherlands.

Coupled with the comparatively higher PE threshold and narrower scope of PE profit attribution under the HK-Indo CDTA, it will be easier for turnkey firms to successfully keep their head office’s business profits segregated and outside Indonesia’s tax net. Moreover, Hong Kong’s low domestic tax rate of 16.5% means that it will be feasible for turnkey firms to perform the bulk of services related to the project in Hong Kong before delivering the end product and/or services in Indonesia, to minimize any Indonesian PE and tax exposure.

**Hong Kong as a holding company** – To date, the HK-Indo CDTA is the only CDTA concluded by Indonesia that provides for a dividend withholding tax rate of 5% (the Indonesia-Mauritius treaty also provided for a 5% rate, but that treaty has been terminated). Given that the dividend withholding tax rates under Indonesia’s CDTAs with other Asia Pacific countries typically range from 10% to 15%, the preferential dividend withholding tax rate in the HK-Indo CDTA confers Hong Kong with a distinct advantage as a platform for regional operations. Moreover, the definition of a Hong Kong resident under the CDTA is relatively broad: it only requires a company to be incorporated in Hong Kong or, if incorporated outside Hong Kong, be normally managed or controlled in Hong Kong. This may provide an opportunity for “tax haven” companies currently holding Indonesian investments to re-domicile to Hong Kong to avail of the preferential tax benefits under the HK-Indo CDTA, provided, however, that the company also meets certain “safe harbor” requirements under Indonesia’s domestic tax rules (see below under “Anti-treaty abuse measures”).

Given the increasing economic ties between China and Indonesia, a Hong Kong company (HKCo) can be used as a holding company for a Chinese investor (ChinaCo) to invest into Indonesia, such that the 10% dividend withholding tax rate under the China-Indonesia tax treaty is reduced to 5% under the HK-Indo CDTA. On the other hand, an Indonesian parent company that interposes HKCo as a holding company for Chinese investments would enjoy a reduction of the dividend
withholding tax rate from 10% under the China-Indonesia treaty to 5% under the Hong Kong-China double tax arrangement.

It should be noted that both China and Indonesia have controlled foreign corporation rules, and both have introduced beneficial ownership and substance requirements that need to be met by HKCo for benefits under the CDTA to apply. The Indonesian requirements are discussed in greater detail below.

ChinaCo could subsequently dispose of the Indonesian company (IndoCo) at the level of HKCo. This would generally be tax exempt under the HK-Indo CDTA (provided IndoCo is not a company that derives more than 50% of its asset value directly or indirectly from immovable property situated in Indonesia). Under Hong Kong’s domestic tax law, capital and/or offshore gains derived by Hong Kong investors from the sale of shares in an Indonesian company are not subject to Hong Kong Profits Tax. Conversely, if IndoCo does not carry on a business in Hong Kong, any gain derived from the disposal of its shares in HKCo will not be subject to Hong Kong Profits Tax.

In either case, HKCo should, among other conditions, have a bona fide commercial purpose because both China and Indonesia can challenge indirect transfers of Chinese/Indonesian resident companies via the disposal of offshore intermediaries under their domestic anti-avoidance tax laws.

**Hong Kong intellectual property (IP) holding company** – Out of all of Indonesia’s tax treaties, the HK-Indo CDTA is one of only two to provide a royalty withholding tax rate of 5%. HKCo may thus be used as an IP holding company to enjoy the lower royalty withholding tax rate under the HK-Indo CDTA.

If structured properly, IndoCo may be able to obtain a deduction of 25% on the royalty expense. HKCo would only be subject to a low domestic Profits Tax rate of 16.5% on its royalty income and may receive a foreign tax credit for the 5% withholding tax paid. Provided certain conditions are satisfied, HKCo also may be able to claim a deduction for the acquisition costs of patent rights and rights to know-how. The Financial Secretary of Hong Kong announced in the 2010/11 Budget Speech that the scope of this deduction would be extended to registered trademarks, copyrights and registered designs, subject to the approval of the legislative council and enactment of the relevant legislation.

Under certain facts and circumstances, HKCo may be able to claim the royalty as nontaxable offshore income. However, it may be more difficult to claim a reduced royalty withholding tax under the HK-Indo CDTA and a deduction for the royalty expense.

**Anti-treaty abuse measures**

The HK-Indo CDTA contains an article that empowers Hong Kong and Indonesia to apply their domestic anti-avoidance laws to prevent the application of treaty benefits in treaty shopping structures. The dividends, interest and royalty articles also contain provisions that deny the CDTA benefits for a taxpayer whose main purpose or one of whose main purposes in structuring the transaction is that of availing itself of benefits under that article.

Indonesia has introduced various safe harbor conditions under its domestic tax regulations to prevent tax treaty abuse, with effect from 1 January 2010. Apart from certain categories of nonresident entities (these include listed companies and institutions specifically mentioned in Indonesia’s treaties or that have been approved by Indonesia and its treaty partner), a nonresident company wishing to avail itself of treaty benefits under any of Indonesia’s treaties would have to satisfy all of the safe harbor conditions. Broadly, the safe harbor conditions stipulate that the nonresident company should have a purpose other than solely utilizing treaty benefits. It also should have its own management that is authorized to perform the company’s transactions, maintain employees, carry out active business activities, be subject to tax on the income received from Indonesia in its country of residence and pay not more than 50% of its total income to fulfill obligations to other parties. As these safe harbor conditions are relatively new, it remains to be seen how stringently they will be enforced by the Indonesian tax authorities in practice.

On its part, Hong Kong has anti-tax avoidance provisions under its domestic tax laws that can be invoked by the Inland Revenue Department (IRD) if a taxpayer obtains a tax benefit from a transaction (or would have obtained a benefit but for the anti-avoidance provisions), and the “sole or dominant purpose” of the transaction is to obtain the tax benefit. It appears that the HK-Indo CDTA would cast a wider net than Hong Kong’s domestic anti-avoidance provisions because a transaction that has as “one of its main purposes” achieving a tax benefit would be caught, as opposed to a transaction with a “sole or
dominant” purpose of obtaining a tax benefit. Nevertheless, we are not aware of any published anti-avoidance cases involving taxpayers seeking to claim tax benefits under Hong Kong’s CDTAs. As such, it is not entirely clear how the IRD would approach such matters.

Hong Kong: responsible and competitive global player

Hong Kong, having recently enacted amendments to its domestic exchange of information (EOI) laws (Inland Revenue (Amendment) Ordinance 2010) that allow it to adopt the updated (2004) OECD EOI standards and exchange broader information under its CDTAs, has gathered momentum toward achieving its goal of signing at least 12 CDTAs that contain the updated EOI standards. As of the date of this article, apart from the HK-Indo CDTA, Hong Kong has signed five such CDTAs (with Austria, Brunei, Hungary, Kuwait and the Netherlands) and has concluded another five (with France, Ireland, Lichtenstein, Japan and Switzerland). The third protocol to Hong Kong’s existing double tax arrangement with China, which serves to incorporate the latest EOI standards, was signed on 27 May 2010. In the meantime, some of Hong Kong’s existing CDTAs are also in the process of being re-negotiated to incorporate the latest EOI standards. Hong Kong is therefore on track to achieve its goal of being moved to the OECD’s “white list.”

Apart from consolidating its role as a responsible global player in the international arena, Hong Kong’s move in expanding its CDTA network should transform its business landscape by providing greater tax benefits and certainty for cross-border businesses.

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