

UNITED STATES TREASURY DEPARTMENT TECHNICAL EXPLANATION OF 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 RESPECT TO TAXES ON INCOME,  
SIGNED AT JAKARTA ON JULY 11, 1988

GENERAL EFFECTIVE DATE UNDER ARTICLE 30: 1 JANUARY 1990

The negotiations of the Convention began in 1971 and agreement was reached on most provisions in 1972. The draft text was subsequently amended in various respects, most recently to reflect changes in U.S. law introduced by the Tax Reform Act of 1986. However, to a large extent the Convention predates the Treasury Department's Model Income Tax Convention, published in 1981. Thus, it retains many of the characteristics of earlier U.S. Income Tax Conventions, particularly in format. The Convention also reflects certain provisions of the Model Income Tax Conventions published by the Organization for Economic Cooperation and Development in 1977 ("OECD model") and by the United Nations in 1980 ("U.N. model").

The Technical Explanation is an official guide to the Convention. It reflects policies behind particular Convention provisions, as well as understandings reached with respect to the interpretation and application of the Convention.

The explanation of each article will include an explanation of any Protocol provisions relating to that article.

References to "he" and "his" should be read to mean also "she" and "her".

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## ARTICLE 1 Personal Scope

Article 1 States that the Convention is applicable to residents of the United States or Indonesia or of both countries. Residence is defined in Article 4 (Fiscal Residence). This is a general rule to which there are certain exceptions. For example, Article 28 (General Rules of Taxation) provides, among other things, that the United States generally reserves the right to tax its citizens and certain former citizens in accordance with its domestic law, i.e., without regard to their place of residence. The assurances of non-discrimination provided in Article 24 (Non-discrimination) and the exchange of information provisions of Article 26 (Exchange of Information) are not restricted by this Article, and thus may apply to residents of third countries, as may certain other provisions, such as paragraph 2 of Article 7 (Source of Income) and paragraph 1 of Article 10 (Related Persons).

## ARTICLE 2 Taxes Covered

Paragraph 1 identifies the existing taxes to which the Convention applies in each country.

In the case of the United States, the taxes covered are the income taxes imposed by the Internal Revenue Code, but not including the accumulated earnings tax, the personal holding company tax, or social security taxes. It is understood that the reference to the Internal Revenue Code includes the amendments made by the 1986 Tax Reform Act and the technical corrections thereto. Except for purposes of non-discrimination (Article 24) and exchange of information (Article 26), the Convention does not apply to Federal taxes other than income taxes, such as

excise, sales, unemployment, or gift and estate taxes. State and local taxes are not covered by the Convention.

In the case of Indonesia, the Convention applies to the income tax, including the company tax to the extent provided in the income tax, and the tax on interest, dividends, and royalties. Other national level taxes are also covered for purposes of Articles 24 (Non-discrimination) and 26 (Exchange of Information).

Paragraph 2 provides that taxes imposed after the date of signature of the Convention also are covered if they are substantially similar to the taxes referred to in paragraph 1.

In accordance with paragraph 5 of Article 26 (Exchange of Information), the competent authorities agree to advise each other of significant changes in their tax laws and of other official decisions affecting the application of the Convention.

### ARTICLE 3 General Definitions

Paragraph 1 defines the meaning of some terms as they are used in the Convention. Unless the context otherwise requires, the defined terms have the same meaning throughout the Convention. A number of other important terms are defined in other articles. For example, See Article 4 (Fiscal Residence), Article 5 (Permanent Establishment), and paragraph 3 of Article 13 (Royalties).

Paragraph 1 defines the geographical scope of the two countries to include the adjacent seas to the extent that the respective country has rights over such areas in accordance with international law. An accompanying exchange of notes confirms that Indonesia respects international rights and obligations with respect to transit of its arch pelagic waters in accordance with international law as reflected in Part IV of the 1982 United Nations Convention on the Law of the Sea. The United States does not, for purposes of the Convention, include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory.

The definitions of the terms "person", "company", and "international traffic" are consistent with the definitions in the U.S. Model Draft Income Tax Convention of June 1981.

The competent authority for the United States is the Secretary of the Treasury or his authorized representative. The competent authority for Indonesia is the Minister of Finance or his authorized representative.

The terms "United States tax" and "Indonesian tax" do not include penalty and interest charges. However, the Competent authorities may, in accordance with Article 25 (Mutual Agreement Procedure), seek to ensure that such penalties or interest are imposed or paid in a manner consistent with the objectives of the Convention.

Paragraph 2 provides that, in general, undefined terms shall be defined according to the

law of the Contracting State whose tax is being determined. However, if the meaning differs from that under the law of the other Contracting State, or if it is not readily determinable, the competent authorities may establish a common meaning for the purposes of applying the Convention.

#### ARTICLE 4 Fiscal Residence

This Article defines those persons who are residents of the United States or Indonesia for purposes of the Convention. Paragraph 1 begins by Stating that a person who is liable to tax as a resident under the taxation laws of a Contracting State is a resident of that State. A U.S. partnership, estate, or trust is considered a U.S. resident only to the extent that the income it derives is subject to U.S. tax as the income of a U.S. resident, either in its hands or in the hands of its partners or beneficiaries. (A similar rule is not needed in the case of Indonesia, which generally taxes partnerships and trusts as corporations and estates as individuals.) The references to "liable to tax" and "subject to tax" in paragraph 1 do not cause a tax-exempt organization to lose its status as a resident.

A person who is a resident of only one of the Contracting States under their respective taxation laws need look no further. Paragraphs 2 and 4 address cases of dual residence.

If an individual is considered a resident of both States under their respective domestic laws, paragraph 2 provides a series of "tie breakers" to assign a single residence for purposes of the Convention. The first test is where the individual has a permanent home, i.e., where he resides with his family. If the individual has a permanent home in both countries or in neither of them, he is deemed to be a resident of the State with which his personal and economic relations are closer. If that test is inconclusive, the deciding factor is where he has a habitual abode. If the individual has a habitual abode in both States or in neither of them, he is deemed to be a resident of the State of which he is a citizen. If Citizenship fails to assign a single residence, the competent authorities are charged with settling the question.

Once an individual is determined to be a resident of a Contracting State under paragraph 1 or 2, that definition of residence prevails for all purposes of the Convention, including the "saving clause" of Article 28 (General Rules of Taxation).

Paragraph 4 provides that a company which under domestic tax laws is a resident of both Contracting States will be considered a resident only of the State in which it is organized or incorporated.

#### ARTICLE 5 Permanent Establishment

The rules governing the taxation by a Contracting State of business income derived by a resident of the other State utilize the concept of a "permanent establishment". Paragraph 1 of this

Article defines that concept in general terms and the following paragraphs give some specific illustrations.

Where a resident of one Contracting State furnishes the services of personnel or employees in the other State, the resident will be considered to have a permanent establishment in the latter State if the services continue at the same or a connected project for more than 120 days in a twelve-month period. If such services are rendered for less than 30 days in any taxable year, a permanent establishment will not exist for that year, although the 30 days will count toward the threshold of 120 days in twelve months.

These 120-day thresholds are shorter than the minimum of 183 days preferred by the United States in Conventions with developing countries. (The U.S. Model provides a 12-month threshold for construction sites and drilling rigs and no special rule for services.) They represent a compromise with the Indonesian position that the threshold for such activities should not exceed 90 days. In the absence of the Convention, the liability to taxation in Indonesia would generally begin on day one. In some other U.S. Conventions with developing countries the thresholds vary from 90 to 183 days for different activities; here the solution was to adopt a standard 120-day test for all such cases.

Paragraph 3 enumerates certain activities which may be undertaken, singly or in combination, without creating a permanent establishment. Those activities include using facilities or maintaining a stock of goods solely for the purposes of storage or display or, as indicated in the Protocol, for the purpose of occasional delivery. A permanent establishment does exist if deliveries are made on a regular basis from a warehouse or other storage facility.

The other activities which do not constitute a permanent establishment when carried on in a Contracting State by a resident of the other State are: maintaining goods belonging to the resident solely for the purposes of processing by another person; maintaining a fixed place of business solely for the purpose of purchasing goods or collecting information for the resident; and maintaining a fixed place of business solely for preparatory or auxiliary activities of the resident, such as advertising, supplying information, or scientific research.

Paragraphs 4, 5 and 7 describe the permanent establishment implications of employees and agents. An independent agent, as explained in paragraph 5, does not constitute a permanent establishment of the enterprises using his services. Paragraph 4 provides that a person other than an independent agent who acts in one of the Contracting States on behalf of a resident of the other State is considered a permanent establishment of that resident if he either

- (a) habitually concludes contracts for the resident, unless his activities are limited to those described in paragraph 3, or
- (b) does not have the authority to conclude in that State contracts but habitually maintains a stock of goods belonging to the resident from which he regularly fills orders or makes deliveries on behalf of the resident and additional activities conducted on behalf of the resident contributed to the sale.

Paragraph 7 provides a special rule for insurance companies. It comes from the U.N. model and was included at the request of Indonesia. An insurance company which is a resident

of one of the Contracting States and which receives premiums from or insures risks in the other State through a person other than an independent agent described in paragraph 5 is considered to have a permanent establishment in the other State; i.e., such a person constitutes a permanent establishment of the insurance company even though he does not have the authority to conclude contracts on its behalf. Paragraph 7 does not apply with respect to reinsurance activities.

Paragraph 6 states that control of one company by another does not of itself cause either company to be a permanent establishment of the other.

## ARTICLE 6 Income from Immovable (Real) Property

This Article provides that income from immovable (i.e., real) property and gain on the disposition of such property may be taxed in the Contracting State where such property is situated. In the United States, the taxes that may be levied include the branch taxes imposed by section 884, where applicable. This rule applies to income from real property of an enterprise or income from such property which is used for the performance of independent personal services, even in the absence of a permanent establishment or fixed base. The Article does not define income from real property, which is defined under the respective taxation laws of the Contracting States. However, it provides that income from real property includes income from the extraction of minerals and other natural resources, gain on the disposition of the right giving rise to such income, and income from the use in any form or the leasing of real property. Income on indebtedness secured by immovable property or secured by a right giving rise to income from the extraction of natural resources is not considered income from real property. Such income is treated as interest subject to the provisions of Article 12 (Interest).

This Article does not prescribe the manner in which real property income is to be taxed by the State of source. However, both the United States and Indonesia allow taxation on a net basis.

Income from immovable property may also be taxed in the Contracting State of residence (or citizenship), in accordance with paragraph 3 of Article 28 (General Rules of Taxation), subject to relief from double taxation in accordance with Article 23 (Relief from Double Taxation).

## ARTICLE 7 Source of Income

This Article provides rules for determining the source of items of income covered by the Convention. It is important in implementing the general rule set forth in paragraph 1 of Article 28 (General Rules of Taxation) that a contracting State may tax a resident of the other State only on income derived from Sources in the first-mentioned State. Paragraph 1 of Article 23 (Relief from Double Taxation) allows the United States to apply the source rules of the Internal Revenue

Code, rather than the source rules of this Article, solely for the purpose of limiting the foreign tax credit to income from sources without the United States.

Dividends paid by a resident of a Contracting State have their source in that State.

Interest paid by a resident of a Contracting State, or by that State or a political subdivision or local authority thereof, generally has its source in that State. However, if the person paying the interest has a permanent establishment in one of the Contracting States and the permanent establishment bears the interest payment, the interest has its source where the permanent establishment is situated. This rule applies whether or not the person paying the interest is a resident of one of the Contracting States; it would apply, for example, to interest paid by a bank incorporated in a third country which is borne by a branch of that bank in Indonesia or the United States. For this purpose, interest is "borne" by a permanent establishment if it is deductible by the permanent establishment.

Royalties, as defined in Article 13 (Royalties), have their source in the State where the right or property giving rise to the royalty is used.

Income from immovable property has its source where the property is situated.

Income from the rental of tangible personal property (movable property) also has its source where the property is situated, except in the case of ships, aircraft or containers used in international traffic. Income from the rental of such Ships, aircraft or containers is either taxable only in the State of residence under Article 9 (Shipping and Air Transport) or is defined as a royalty under Article 13 (Royalties) and sourced accordingly.

Income derived by an individual for personal services has its source where the services are performed. An exception applies to remuneration for services performed by the crew of a ship or aircraft used in international traffic, which has its source in the State of residence of the operator of the ship or aircraft. Pensions and similar remuneration from private Sector employers paid with respect to past services are sourced where the services were performed. This rule does not apply to payments covered by Article 22 (Social Security Payments), which are sourced in a Contracting State if paid out of public funds of that State or a political subdivision or local authority thereof. (The source rule says "only" if paid out of public funds; but since Article 22 defines such payments as made from public funds, this will always be the case.)

Income from the disposition of a U.S. real property interest or of an interest in real property situated in Indonesia is treated as income from sources in the United States or Indonesia, respectively.

Notwithstanding the above rules, income which is attributable to a permanent establishment in a Contracting State is treated as income from sources in that State, provided that the property or right giving rise to the income is effectively connected with that permanent establishment.

The source of any item of income not specified in this Article is determined under the

domestic laws of the respective States. If the result under the domestic laws is unclear or differs, the competent authorities may establish a common source rule for purposes of the Convention. This approach differs from the position of the U.S. Model, which establishes taxing rules for specified types of income and reserves to the State of residence the taxation of income for which a specific taxing rule is not provided. However, some conventions, especially with developing countries, allow taxation of such residual income in the State of source as well. (See, for example the U.S. Income Tax Conventions with Barbados and Jamaica. The proposed treaty with India also contains such a provision.) In such a case, the result is essentially the same as under this Article.

## ARTICLE 8 Business Profits

This Article provides rules for the taxation by a Contracting State of income from business activity carried on by a resident of the other State.

Paragraph 1 provides that the business profits of a resident of a Contracting State shall be taxable only by that State unless the resident carries on business in the other Contracting State through a permanent establishment there. If the enterprise has a permanent establishment in the other Contracting State, that other State may tax the portion of the enterprise's business profits which is attributable either to the permanent establishment itself, or to sales in that other State of goods or merchandise of the same kind as those sold through the permanent establishment, or to other business transactions carried on in that other State which are of the same kind as those effected through the permanent establishment. The reference to similar transactions, which is taken from the U.N. Model Convention, gives the State in which the permanent establishment is situated a broader taxing right over the business profits of an enterprise of the other State than under the U.S. or OECD Model Conventions, but it is narrower than the limited "force of attraction" rule of Code Section 864(c)(3).

Paragraph 2 provides that the profits to be attributed to the permanent establishment are those which it might be expected to make if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing on an arm's-length basis with its home office. The term "attributable to" means that, subject to the rules described above, the limited "force-of-attraction" rule of Code section 864(c)(3) does not apply for U.S. tax purposes under the Convention. Profits may, however, be from sources within or without a Contracting State and be "attributable to" a permanent establishment. Thus, for example, items of income described in Section 864(c)(4) of the Code which are attributable to a permanent establishment in the United States are subject to tax by the United States.

Paragraph 3 provides that there shall be allowed as deductions those expenses reasonably connected with the income of the permanent establishment, whether incurred in the State where the permanent establishment is located or elsewhere. Deductible expenses include a reasonable allocation to the permanent establishment of administrative and executive expenses. A portion of research and development expenses, interest, and other expenses incurred by the home office for purposes of the enterprise as a whole may be deductible by the permanent establishment if they

are reasonably connected with its profits. The paragraph adds the provision of the U.N. Model that payments of interest, royalties, fees and commissions by a permanent establishment to its home office are not deducted in determining the profits of the permanent establishment except to the extent that they represent reimbursement of costs incurred (i.e., no profit is permitted on Such payments).

Paragraph 4 provides that the mere purchase by a permanent establishment of goods or merchandise for the resident of which it is a permanent establishment shall not result in profits being attributed to the permanent establishment.

Paragraph 5 provides that, where business profits include items of income dealt with separately in other articles of the Convention, the provisions of those separate articles supersede the provisions of this Article. Thus, for example, the taxation of income from international shipping and air transport is dealt within Article 9 (Shipping and Air Transport). The taxation of dividends, interest, and royalties is controlled by Articles 11 (Dividends), 12 (Interest), and 13 (Royalties); however, those Articles provide that, where the assets giving rise to dividends, interest, or royalties derived by a resident of a Contracting State are effectively connected with a permanent establishment or fixed base of that resident in the other Contracting State, the resulting income is taxable on a net basis in that other State in accordance with this Article or Article 15 (Independent Personal Services).

## ARTICLE 9 Shipping and Air Transport

Paragraph 1 states the general rule that a resident of a Contracting State shall be exempt from tax by the other State on income derived from the operation of ships or aircraft in international traffic. "International traffic" is defined in Article 3 (General Definitions). This Article takes precedence over Article 8 (Business Profits). Thus, the exemption applies even if the income is attributable to a permanent establishment in the other State.

Paragraph 2 defines the scope of income eligible for the exemption. Income from the operation of ships or aircraft in international traffic is defined to include income from the rental on a full basis (i.e., fully staffed and equipped) of ships or aircraft used in international traffic. The treatment of rentals on a bareboat basis distinguishes between ships and aircraft. Income from the rental on a bareboat basis of aircraft operated in international traffic is considered income from the international operation of aircraft. Income from the rental of ships on a bareboat basis is considered income from the international operation of ships, provided that the ship is operated in international traffic and that the lessee is not a resident of, or a permanent establishment in, the other Contracting State. Thus, for example, a U.S. lessor of a ship operated between the United States and Indonesia will not qualify for exemption from Indonesian tax on the rental income from that lease if the lessee is an Indonesian company or the Indonesian permanent establishment of a U.S. company. In such cases, the rental payment is a deductible expense for purposes of Indonesian corporate tax, and Indonesia was not willing to forgo tax on the recipient of the income. Such payments will be treated as royalties subject to the provisions of Article 13 (Royalties).

Income derived from the use or maintenance of containers and related equipment for the transport of the containers is included in the definition of income from international traffic if the containers are used in international traffic and the income is incidental to income described in paragraph 1, i.e., if the resident deriving the income is itself engaged in international shipping or aircraft operations and the container leasing activity is relatively minor in relation to those operations. For the treatment of other container leasing operations, see the discussion of Article 13 (Royalties).

Paragraph 3 provides that, notwithstanding Article 14 (Capital Gains), gains derived by a resident of one of the Contracting States from the disposition of ships or aircraft operated in international traffic and of containers used in international traffic are taxable only in that State.

The Protocol confirms that the Convention has no effect with respect to legal claims concerning the taxation of income from international shipping and air transport derived in years prior to the entry into force of the Convention. A taxpayer may pursue any legal remedies available with respect to claims affecting prior years. As noted, this is simply a clarification of existing legal rights.

#### ARTICLE 10 Related Persons

This Article complements section 482 of the Code and confirms the right of the Contracting States to reallocate items of income in certain cases. Under paragraph 1, if conditions between related persons in their commercial or financial relations differ from those that would be made between independent persons, any profits that would, but for those conditions, have accrued to one of the persons, but by reason of those conditions have not so accrued, may be included in the profits of that person and taxed accordingly.

Paragraph 2 provides that persons are related for purposes of the Convention where one person participates directly or indirectly in the management, control, or capital of the other, or the same persons participate directly or indirectly in the management, control, or capital of both.

Paragraph 3 describes the consequences of an adjustment made by a Contracting State in accordance with paragraph 1. Where a Contracting State makes such an adjustment, the other Contracting State shall make a corresponding adjustment to the amount of tax which it charged the related enterprise, in order to avoid double taxation. It is implicit in the language of the paragraph that the other Contracting State agrees that the adjustment is appropriate and reflects the result which would occur under arm's-length conditions. In determining the amount of such adjustments, other provisions of the Convention are to be taken into account. Thus if, as a result of the adjustment, one enterprise is determined to have made a distribution of profits to the other, the provisions of Article 11 (Dividends) may apply to the deemed distribution. If necessary, the competent authorities shall consult to resolve any differences in the application of these provisions, or to coordinate the application of interest and penalties.

This Article does not limit the application of any internal law provisions in either Contracting State designed to place transactions between related enterprises on an arm's-length basis. Thus, it does not limit the right of the United States to apply Section 482 of the Code.

## ARTICLE 11

### Dividends

This Article governs the taxation by a Contracting State of dividends paid by a company which is a resident of that State to a resident of the other Contracting State. It also governs the application of branch taxes imposed in addition to the tax on profits.

Dividends may be taxed in both Contracting States, in the country of source and the country of residence. However, the tax imposed by the country of source may not exceed 15 percent of the gross amount of the dividends when the beneficial owner is a resident of the other Contracting State. In the absence of the Convention, the U.S. tax rate would be 30 percent and the Indonesian rate 20 percent.

The limitation of tax at source does not apply with respect to the U.S. taxation of U.S. citizens resident in Indonesia. (See paragraph 3 of Article 28 (General Rules of Taxation).)

This limitation of tax at source also does not apply if the shares giving rise to the dividends are effectively connected with a permanent establishment or fixed base which the owner of the dividends has in the Contracting State where the dividends have their source. In such a case the dividends are taxable to the permanent establishment or fixed base in accordance with Article 8 (Business Profits) or Article 15 (Independent Personal Services), as appropriate.

Paragraph 4 authorizes the Contracting States to impose a branch profits tax, in addition to the corporate tax, on the profits of a permanent establishment in that State of a resident of the other State. The tax base is defined by each Contracting State in accordance with its law, but is net of the corporate tax imposed by that State on the profits of the permanent establishment. In the United States, the tax base is the "dividend equivalent amount" as defined in Code section 884(b). Paragraph 4 also authorizes the Contracting States to impose a tax on interest payments allocable to a permanent establishment of a resident of the other Contracting State. As explained in the accompanying protocol, the reference to interest payments "allocable" to the permanent establishment means, for purposes of U.S. law, any excess of interest deducted by the U.S. permanent establishment of a resident of Indonesia over the interest paid by such permanent establishment. The abbreviated form of this provision with respect to branch taxes reflects the timing of the negotiations. The Convention was initialed prior to the enactment of the Tax Reform Act of 1986. To minimize subsequent changes, the pre-existing provision designed to permit Indonesia's branch profits tax was modified to provide also for the U.S. branch taxes. The additional taxes are limited to a rate of not more than 15 percent, reciprocally, except as provided in paragraph 5. In the absence of the Convention, the U.S. tax would be imposed at 30 percent and the Indonesian tax at 20 percent.

Paragraph 5 provides that the 15 percent maximum rate specified in paragraph 4 does not

apply with respect to contracts between the Indonesian government or an entity thereof and a U.S. resident concerning Indonesian oil, gas or other mineral products. At present, Indonesia imposes its statutory rate of 20 percent in such cases.

## ARTICLE 12

### Interest

This Article governs the taxation by a Contracting State of interest derived from sources within that State by a resident of the other Contracting State. The source rule is provided in Article 7 (Source of Income). The taxation of certain excess interest of a permanent establishment is covered by Article 11 (Dividends), paragraph 4, and by the Protocol.

Interest derived by a resident of one Contracting State from sources in the other Contracting State may be taxed by both States. However, the tax imposed at source may not exceed 15 percent of the gross interest when the beneficial owner of the interest is a resident of the other State; and no tax may be imposed at source when the interest is derived by the other Contracting State or any agency or instrumentality thereof which is exempt from income tax in that other State. In the absence of the Convention, there would generally be no U.S. tax on portfolio interest or on interest derived by the Government of Indonesia that is exempt under section 892 of the Internal Revenue Code, and a 30 percent tax would be withheld on other interest. The Indonesian statutory rate of tax on interest paid to nonresidents is generally 20 percent.

The limitation of tax at source does not apply with respect to the U.S. taxation of U.S. citizens resident in Indonesia. (See paragraph 3 of Article 18 (General Rules of Taxation).)

The limitation of tax at source also does not apply if the indebtedness giving rise to the interest is effectively connected with a permanent establishment or fixed base which the owner of the interest has in the State where the interest has its source. In such a case the interest is taxable to the permanent establishment or fixed base in accordance with the provisions of Article 8 (Business Profits) or 15 (Independent Personal Services), as appropriate.

Paragraph 5 provides that, where interest paid to a related person exceeds the amount which would be paid to an unrelated person, the excess amount is not affected by this Article, but may be taxed by each Contracting State in accordance with its law, including other provisions of the Convention which may be applicable. For example, if the excess payment is characterized as a dividend, the provisions of Article 11 (Dividends) would be applicable.

The definition of interest in paragraph 6 is substantially the same as in the U.S. Model.

## ARTICLE 13

### Royalties

This Article governs the taxation by a Contracting States of royalties derived from

sources within that State by a resident of the other Contracting State.

Such royalties may be taxed by both Contracting States, the country of source and the country of residence. However, paragraph 2 limits the tax at source when the beneficial owner of the royalties is a resident of the other State. The limits are 10 percent of the gross payment for the rental of equipment and 15 percent of the gross payment in other cases.

The 10 percent rate applies to payments for the use of, or right to use, industrial, commercial or scientific equipment, other than payments for the rental of ships, aircraft or containers which are exempt from tax under Article 9 (Shipping and Air Transport). Thus, for example, income from the bareboat leasing of a plane operated in international traffic is covered by Article 9 and not by this Article. Income from the leasing of containers by a leasing company and payments for the leasing of drilling rigs and similar equipment are covered by paragraph 3(b) of this Article. The treatment of payments for the leasing of equipment as royalties differs from the position of the U.S. Model that such income constitutes business profits. It represents a significant concession by the United States in order to conclude the Convention. Indonesia, as a developing country, seeks to preserve taxation at source of payments deducted from the Indonesian tax base and paid to nonresidents. It maintains this position even in income tax conventions with countries which provide tax incentives to investment in Indonesia. Since the United States does not provide such an investment incentive by treaty, Indonesia views the reduction in its tax on such rentals from 20 to 10 percent of the gross payment as a significant concession on its part.

The 15 percent rate applies to royalties with respect to copyrights, including film or tape rentals, patents, designs, models, plans, secret processes or formulas, trademarks and information concerning industrial, commercial or scientific experience. It also applies to gain on the disposition of any right or property giving rise to a royalty if the amount realized is contingent on the productivity, use or disposition of such property or rights. The 15 percent rate is a maximum. It does not prejudice any lower rate which may be agreed to between a Contracting State and residents of the other State. For example, if film rentals derived from Indonesia by U.S. residents are subject to an effective tax rate of less than 15 percent of the gross amount, that regime will continue to apply.

The limitations of tax at source do not apply to the U.S. taxation of U.S. citizens resident in Indonesia. (See paragraph 3 of Article 28 (General Rules of Taxation).)

The limitations of tax at source provided in paragraph 2 also do not apply if the property or rights giving rise to the royalty are effectively connected with a permanent establishment or a fixed base which the recipient has in the Contracting State where the royalty arises. In that case the provisions of Article 8 (Business Profits) or Article 15 (Independent Personal Services) apply.

Paragraph 5 provides that, where a royalty paid to a related person exceeds the amount that would be paid to an unrelated person, the excess amount is not affected by this Article but may be taxed by each Contracting State in accordance with its law, including other provisions of the Convention which may be applicable. For example, if the excess payment is characterized as

a dividend, the provisions of Article 11 (Dividends) would be applicable.

## ARTICLE 14 Capital Gains

Paragraph 1 addresses the taxation of gain on dispositions of real property. It States the basic rule that gain on the disposition of real property situated in one of the Contracting States may be taxed by that State. In the case of the United States the tax levied includes the branch taxes imposed by section 884, where applicable. Real property situated in the United States is defined to include a United States real property interest: thus, the United States retains its right to tax in accordance with section 897 of the Internal Revenue Code.

Paragraph 2 provides that gain derived by a resident of a Contracting State from the disposition of capital assets, other than those covered in paragraph 1, is taxable only in that State, with two exceptions. The exceptions allow the other Contracting State to tax

(1) gain on property effectively connected with a permanent establishment or fixed base which the recipient has in that other State, in which case Article 8 (Business Profits) or Article 15 (Independent Personal Services) applies, and

(2) gain derived by an individual who is present in that other State for a total of 120 days or more during the taxable year, in which case the gain is taxed in accordance with domestic law.

Gain on the sale of securities, for example, could be included in the second category. Where one of the two exceptions applies, the State of residence (or citizenship) may also tax the gain, and will provide relief from double taxation in accordance with Article 23 (Relief from Double Taxation).

Paragraph 3 clarifies that gain derived by a resident of a Contracting State from the deemed alienation of assets described in paragraph (2)(i) of Article 5 (Permanent Establishment) which are used in exploring for or exploiting oil and gas resources is taxable only in the State of residence. The United States gives up its tax on the gain on deferred dispositions, imposed by section 864(c)(7) of the Internal Revenue Code under paragraph 2 of this Article; under paragraph 3, neither Contracting State will treat the withdrawal of a drilling rig from its territory as a deemed disposition subject to an "exit tax" or "balancing charge" on the deemed gain.

Gain on the disposition of ships. Aircraft and containers used in international traffic is covered under Article 9 (Shipping and Air Transport) rather than under this Article.

## ARTICLE 15 Independent Personal Services

This Article concerns the taxation of income from the performance of independent personal services. Independent personal services are, in general terms services performed by an individual for his own account where he receives the income and bears the losses arising from the services. Generally, they include personal services performed by a self-employed individual,

a sole proprietor, or a partner, but not services performed as an employee or an officer of a company. Services performed as a director of a corporation are typically independent services, except to the extent that the director is also an officer of the corporation.

Paragraph 1 states that, with two exceptions, an individual resident of one of the Contracting States may be taxed only by that State with respect to income from independent personal services. The exceptions occur if the individual has a fixed base in the other Contracting State for the purpose of performing his Services, or if the individual stays in that other State for more than 120 days in a period of 12 consecutive months. In the first case, the other Contracting State may tax the income attributable to the fixed base. In the second case, the other Contracting State may tax the income attributable to the services performed in its territory. In either case the State of residence (or citizenship) may also tax that income, subject to providing relief from double taxation in accordance with Article 23 (Relief from Double Taxation).

## ARTICLE 16 Dependent Personal Services

This Article concerns the taxation of income from the performance of personal services as an employee or company officer when the person performing the services is a resident of one of the Contracting States and the services are performed in the other Contracting State. Paragraph 1 provides that such income may be taxed in the State of residence of the recipient and, except as provided in paragraph 2, may also be taxed in the other State where the services are performed.

Paragraph 2 sets forth the exceptions. The other (i.e. source) State may not tax the remuneration if the individual is present in that State for less than 120 days in a period of 12 consecutive months and the remuneration is paid by or on behalf of an employer who is not a resident of that State and is not borne as such or reimbursed (i.e., deducted) by a permanent establishment which the employer has in that State. Restated affirmatively, if a dependent employee who is a resident of one of the Contracting States performs services in the other Contracting State, the other State may tax the remuneration for those Services if the individual remains in that other State for 120 days in 12 consecutive months, or if the remuneration is paid by an employer which is a resident of that other State or is borne by a permanent establishment in that other State of a nonresident employer.

Paragraph 3 provides a special rule for persons regularly employed aboard a ship or aircraft engaged in international traffic. The remuneration for such services is taxable only by the State of which the operator of the ship or aircraft is a resident. However, in accordance with paragraph 3 of Article 28 (General Rules of Taxation) each State reserves the right to tax its residents and citizens. Thus, a U.S. resident or citizen employed as a member of the crew of an Indonesian aircraft would be Subject to U.S. tax on the remuneration for his services (and eligible for a foreign tax credit in accordance with U.S. law).

## ARTICLE 17

## Artistes and Athletes

This Article provides exceptions to the rules of Articles 15 (Independent Personal Services) and 16 (Dependent Personal Services) for remuneration derived by public entertainers and athletes. The remuneration of producers, directors, technicians, and others who are not entertainers or athletes is covered by Articles 15 and 16.

When an individual who is a resident of one of the Contracting States performs as a public entertainer or athlete in the other Contracting State, the latter State may tax the remuneration for such services if the gross amount, including reimbursed expenses, exceeds \$2,000 U.S. dollars (or the equivalent in Indonesian rupiahs) in any consecutive 12 months. This is a compromise between Indonesia's preferred position, which is to tax such income at source with no threshold (as in the OECD and U.N. models), and the U.S. Model, which allows a higher threshold. (The \$2,000 figure assumes that, in the typical case, a U.S. entertainer or athlete performing in Indonesia will be doing so as part of a broader tour which includes visits to other countries in the area, in which case the expenses associated with the visit to Indonesia will be the incremental amount, not the full costs of the travel from and to the United States.) Paragraph 3 provides further relief in the case of visits supported or sponsored by the Contracting State of which the individual is a resident.

Paragraph 2 provides that where income for the performance of personal services by an entertainer or athlete does not accrue to that individual, but is diverted to another person, the income may be taxed in the State where the services are performed, notwithstanding the provisions of Articles 8 (Business Profits) and 15 (Independent Personal Services), i.e., notwithstanding that the person receiving the income does not have a permanent establishment or fixed base in that State. This is an anti-abuse rule, intended to have the same effect as the corresponding provision in the U.S. Model.

Paragraph 3 provides that the provisions of paragraphs 1 and 2 do not apply to income from profits derived from services performed in a Contracting State during a visit which is substantially supported or sponsored by the other Contracting State. The competent authority of the sending State must certify that the visit qualifies under this provision. This rule, which is similar to a provision in the U.S. - Philippines income tax treaty, is intended to remove from the scope of this Article cultural exchanges and performances which the governments encourage by providing substantial sponsorship or support. In such cases, the taxation of the remuneration will be governed by Article 15 (Independent Personal Services) or 16 (Dependent Personal Services).

## ARTICLE 18 Government Service

This Article concerns the taxation of remuneration and pensions paid out of public funds to individuals for services rendered in the discharge of governmental functions.

Paragraph 1 deals with remuneration other than pensions. It is based on the OECD and U.N. models. In general, payments to an individual by a Contracting State or a political

subdivision or local authority thereof for services rendered to it may be taxed only in that State. However, such remuneration may be taxed only in the other Contracting State if the services are performed in the other State by an individual who is a resident of that other State and either is a national of that other State or did not become a resident there solely for the purposes of performing those services. Thus, for example, Indonesia may not tax the remuneration of a U.S. Government employee working in Indonesia unless that employee is

- (1) a resident and citizen of Indonesia, or
- (2) a resident of Indonesia who did not become a resident solely for the purpose of performing services for the U.S. Government there.

Certain locally hired employees might come within category 2.

Paragraph 2 deals with pensions paid out of public funds of a Contracting State or political subdivision or local authority thereof to an individual for past services rendered. Such pensions may be taxed only in the State from which they are paid.

The provisions of paragraphs 1 and 2 do not affect the right of a Contracting State to tax its own citizens or permanent residents. However, in accordance with paragraph 4 of Article 28 (General Rules of Taxation), the "saving clause" does not affect the benefits conferred by a Contracting State under this Article on individuals who are not citizens of, or residents having immigrant status in, that State. Thus, for example, a pension paid by the U.S. Government to a former employee who retires to Indonesia may not be taxed by Indonesia unless the individual is a citizen of Indonesia or is admitted as a permanent resident of Indonesia for immigration purposes. In the converse case, the U.S. would not tax a pension paid by the Government of Indonesia to an individual who retires to the United States unless the individual is a U.S. citizen or holds a "green card".

Paragraph 3 makes it clear that remuneration or pensions paid by a Contracting State or political subdivision or local authority thereof with respect to services rendered in connection with a trade or business carried on by either government or a political subdivision or local authority thereof are not covered by this Article but by the applicable provisions of Articles 15 (Independent Personal Services), 16 (Dependent Personal Services), or 21 (Private Pensions and Annuities). Each Contracting State applies the rules of its domestic law in determining whether services are rendered in connection with a trade or business. For example, the United States will apply the standards of section 892.

## ARTICLE 19 Students and Trainees

Paragraph 1 of this Article provides special tax rules for individual residents of one of the Contracting States who visit the other Contracting State solely for the purpose of studying at a recognized educational institution or of studying, doing research or receiving training as a recipient of an award from a charitable organization (in the case of the United States, an organization exempt from income tax under Code section 501(c)(3)) or from either Government or under a technical assistance program entered into by either Government.

The term "solely" as used in paragraph 1 means that the individual must participate in a full-time program of study, research, and/or training. However, he may also undertake a part-time job (as is confirmed by the exemption of certain personal services income provided in paragraph 1(b)(iii)) or may engage in occasional outside activities without losing the benefits of this Article.

The host State agrees to exempt such individuals from tax on:

- (a) remittances from abroad for their maintenance, study, research, or training,
- (b) the award received, and
- (c) not more than \$2,000 per year (or an equivalent amount in Indonesian rupiahs) of remuneration for personal services.

The services must be performed in connection with the study, research, or training or be necessary to provide for the individual's maintenance. If the amount earned exceeds \$2,000, the exemption applies to the first \$2,000. The excess is taxable in accordance with domestic law. The \$2,000 exemption does not reduce any personal exemptions and deductions allowable under domestic law.

The period of exemption for individuals who qualify under paragraph 1 may not exceed five years from the individual's date of arrival in the other State.

Paragraph 2 provides that an individual who is a resident of one of the Contracting States and visits the other State as a business or technical apprentice shall be exempt from tax in that other State on the first \$7,500 of income (or an equivalent amount in Indonesian rupiahs) from personal services. The period of exemption for individuals who qualify under this paragraph may not exceed, 12 consecutive months. It is intended that the 12-month period begin on the date of arrival. The aggregate amount exempt from tax during that period may not exceed \$7,500. Any excess amount earned will be subject to tax under the rules of domestic law, including an allowable personal exemptions and deductions.

## ARTICLE 20 Teachers and Researchers

This Article provides that an individual resident of a Contracting State who is invited by a university, school, or similar educational institution to visit the other Contracting State for the purpose of teaching and/or doing research at that educational institution, is exempt from tax by that other State on the remuneration for such teaching or research for up to two years from his date of arrival in the other State. Although the reference to "recognized" educational institutions found in similar provisions in other U.S. treaties and in paragraph 1 of Article 19 (Students and Trainees) is not mentioned here, that qualification is implicit. The Indonesian requirement that graduates of private universities pass a state examination does not imply that such universities are not recognized; such universities are meant to be covered by this Article. However, the Article is meant to apply to academic or technical programs only, and not to recreational courses. This exemption is available only once to any given individual. Thus, for example, an individual

who spends one or two years teaching in the United States, leaves for a year, and then accepts a teaching or research position at another U.S. university may not claim the exemption during the second visit if he has claimed an exemption under this Article during the first visit. An individual who stays longer than two years will be exempt for the first two years from the date of arrival and will be taxable thereafter.

The exemption provided in this Article with respect to research activities is not available if the research is undertaken primarily for private benefit. Thus, for example, income earned while performing research on cancer for which the rights to any discoveries are owned by a particular drug firm would not qualify, even though the research itself is of public interest.

## ARTICLE 21 Private Pensions and Annuities

Paragraph 1 provides that pensions in respect of past employment which are derived by a resident of one of the Contracting States from private sources in the other Contracting State may be taxed by both States, but the tax imposed by the State of source may not exceed 15 percent of the gross amount paid. Article 7 (Source of Income) defines the source of a pension as where the services to which it relates were performed. This provision does not apply to pensions in respect of government service, which are covered in Article 18 (Government Service), or to social security benefits, which are covered in Article 22 (Social Security Payments). The rule of this paragraph differs from that of the U.S. Model, which reserves the exclusive right to tax private pensions to the country of residence of the recipient (except that the United States, under the "saving clause" may also tax its nonresident citizens); it is a concession to Indonesia's interest, as a developing country, in preserving source-basis taxation.

Paragraph 2 provides that annuities paid to a resident of one of the Contracting States may be taxed only by that State.

Paragraph 3 provides that alimony and child support payments made by a resident of one of the Contracting States to a resident of the other Contracting State are taxable only by the first State, i.e., the State of which the payer is a resident. Thus, in accordance with the Code rules, alimony paid by a U.S. resident to an Indonesian resident will be subject to U.S. tax, withheld by the payer, but there will be no U.S. tax liability on child support payments by a U.S. resident to an Indonesian resident. Both are exempt from tax in Indonesia. In the reverse case, an Indonesian resident paying alimony or child support to a U.S. resident is required to withhold Indonesian tax in both cases. The recipient is not subject to U.S. tax in either case; as this provision is an exception to the saving clause (see paragraph 4(a) of Article 28 (General Rules of Taxation)), the U.S. resident recipient will be exempt from U.S. tax, rather than Subject to tax with a foreign tax credit.

Paragraphs 4, 5, and 6 define the terms "pensions and other similar remuneration", "annuities", and "alimony" as used in this Article. A pension provided in the form of an annuity shall be taxed as a pension.

ARTICLE 22  
Social Security Payments

Social security payments and similar benefits paid out of public funds by one of the Contracting States to an individual resident of the other Contracting State or to a U.S. citizen may be taxed only by the paying State. This Article is an exception to the Saving clause (see paragraph 4(5) of Article 28 (General Rules of Taxation)), so social security benefits paid by Indonesia to U.S. residents and to U.S. citizens resident in Indonesia or in third countries are exempt from U.S. tax.

ARTICLE 23  
Relief from Double Taxation

This Article specifies the method by which each of the Contracting States will avoid international double taxation of its residents, and in the case of the United States its citizens, with respect to income from sources in the other Contracting State.

Paragraph 1 provides that the United States will allow a credit for taxes paid to Indonesia, subject to the limitations of United States law for the taxable year. The Convention does not guarantee an indirect (Section 902) credit, since Indonesian law does not provide a credit for the underlying corporate tax in such cases. In determining the limitation, the source of income is governed by the rules of Article 7 (Source of Income), subject to the source rules of the Internal Revenue Code which apply solely for the purpose of determining the limitation. It is understood by the treaty partners that, for purposes of the alternative minimum tax imposed by the Tax Reform Act of 1986, the foreign tax credit allowable may be limited to 90 percent of the pre-credit liability for such tax.

Paragraph 2 provides that Indonesia will allow a credit for taxes paid to the United States, subject to the limitations of Indonesian law for the taxable year. In determining the limitation, the source of income is governed by the rules of Article 7 (Source of Income).

Each Contracting State will apply its domestic law to determine what is creditable tax.

ARTICLE 24  
Non-discrimination

Paragraph 1 prohibits either Contracting State from imposing more burdensome taxes or related requirements on its residents who are citizens of the other Contracting State than on its resident Citizens. The limitation of this provision to persons resident in a Contracting State does not imply on the part of either State an intent to discriminate among nonresidents on the basis of nationality.

Paragraph 2 ensures non-discriminatory taxation by each Contracting State of permanent

establishments of residents of the other Contracting State relative to the taxation of enterprises carried on by residents of that State. The branch profits tax authorized by paragraph 4 of Article 11 (Dividends) is explicitly excepted from this provision. Non-discriminatory treatment does not require granting the same relief for family circumstances to nonresident individuals as may be available to resident individuals. Nor does it prohibit the withholding of tax on payments by a U.S. partnership to partners who are residents of Indonesia; withholding in this case, as in the case of payments to nonresident aliens of certain other income such as dividends, interest, and royalties, is a reasonable mechanism for collecting the U.S. tax due from persons not continually present in the United States.

Paragraph 3 prohibits discriminatory taxation of resident corporations based on their ownership; i.e., corporations owned by residents of the other Contracting State may not be subject to more burdensome taxes or connected requirements than corporations owned or controlled by residents of the taxing State which are engaged in the same activities. It is understood that this provision does not prevent the United States from imposing tax on a U.S. corporation which makes a distribution in liquidation to an Indonesian corporation. It is also understood that the ineligibility of a corporation with nonresident alien shareholders to make an election to be an "S" corporation does not violate this provision. The ineligibility of such a corporation to make the election is not due to the nationality or residence of its shareholders, but to the fact that they are not subject to U.S. tax on a net basis as are U.S. shareholders.

Paragraph 4 provides that, except where the payments are considered excessive in accordance with the provisions of paragraph 1 of Article 10 (Related Persons), paragraph 5 of Article 12 (Interest), or paragraph 5 of Article 13 (Royalties), interest, royalties, and other disbursements made by a resident of a Contracting State to a resident of the other Contracting State shall be allowed as a deduction in computing taxable income in the first State to the same extent as if the payment were made to a resident of that State. (If a deduction of a payment by one resident to another would be disallowed because the payer's debt exceeded the allowable debt-to-equity ratio, the same ratio would apply in determining the deductibility of a payment to a nonresident.) This is implicit in the language of the U.S. Model, but it is made explicit in this case, at the request of Indonesia, by the addition of the parenthetical reference to debt-to-equity ratios. Similarly, for purposes of taxes on capital, any debt which would be deductible to a resident of a Contracting State if the creditor were also a resident of that State must be allowed as a deduction to the same extent when the creditor is a resident of the other State, taking into account any applicable debt/equity rules.

The provisions of this Article apply not only to the income taxes specified in Article 2 (Taxes Covered), but to all taxes imposed at the national level. The U.S. Model extends this Article to sub-national taxes as well. The limitation to national taxes in this case does not imply any intent to discriminate in application of sub-national taxes, nor is any such practice known to exist.

ARTICLE 25  
Mutual Agreement Procedure

This Article provides for cooperation between the competent authorities of the Contracting States, as defined in Article 3 (General Definitions), to resolve cases of double taxation.

Paragraph 1 provides that if a resident of one of the Contracting States considers that the action of either or both States will result in taxation not in accordance with the Convention, he may present his case to the contracting State of which he is a resident. If the case concerns a complaint of discrimination by the State of residence on the basis of citizenship, he may present the case to the State of which he is a citizen. In any case, a person requesting assistance from the competent authority may also avail himself of any remedies under domestic laws. To be considered by the competent authority, a case must be presented within three years from the first notification of the action giving rise to the potential problem. If the potential taxation not in accordance with the Convention arises from a combination of decisions or actions by both States, the three-year period begins to run from the most recent notification of an action which will result in taxation not in accordance with the Convention.

The competent authority to which the case is presented is to review the case and, if the claim is justified, seek a solution either independently or in conjunction with the competent authority of the other States. Any agreement reached by the competent authorities will be implemented without regard to any time or procedural limitations of domestic law. Thus, for example, the competent authorities will waive the domestic statute of limitations to make a refund under a competent authority agreement. However, no additional tax will be imposed if the statute of limitations has expired.

Paragraph 3 authorizes the competent authorities to seek a mutual agreement on any difficulty arising in applying the Convention and on cases of double taxation arising from situations not directly dealt with in the Convention. For example, the competent authorities may agree to a common definition of a term used in the Convention, to the characterization of a particular item of income, to a common source rule, or to the appropriate allocation of deductions. They may also endeavor to coordinate the provisions of domestic law with respect to penalties and interest.

Paragraph 4 confirms that the competent authorities may communicate directly, including meeting together, for the purpose of implementing this Article.

## ARTICLE 26 Exchange of Information

This Article provides that the competent authorities shall exchange information for the purpose of applying the Convention or the domestic laws covered by the Convention, provided that the taxation under the domestic laws is not contrary to the Convention. The information exchanged may relate to nonresidents as well as to residents of a Contracting State. The State receiving information under this Article must keep it secret in the same manner as information obtained under its domestic laws. The information may be made available only to persons involved in the assessment, collection, administration, or enforcement of the taxes covered by the

Convention, or in the prosecution or determination of appeals in relation to such axes; and the information may be used only for such purposes. It may be disclosed in public court proceedings or in judicial decisions. The General Accounting Office and the tax committees of Congress may have access to the information exchanged, in their capacity of overseeing the administration of the U.S. income tax law, subject to the secrecy requirements applicable to domestic tax information.

Paragraph 2 provides that the obligation to exchange information under this Article does not require a Contracting State to carry out administrative measures contrary to the laws and practice of either State, or to supply information not obtainable in that or the other States under its laws or tax administration, or to supply information which would disclose any trade secret or which it is contrary to public policy in that State to disclose. For example, if one of the States requests the other to furnish information which the first State could not obtain under its own laws and practice, the second State is not required (but is permitted) to comply with that request if its laws and practice permit it to collect such information with respect to domestic tax claims.

Paragraph 3 provides that, subject to the conditions of paragraphs 1 and 2, a Contracting State will obtain information requested by the other Contracting State in the same manner and to the same extent as if the tax in question were its own tax, even though it may have no tax interest in the particular case to which the request relates. Further, the information shall be furnished in the form requested to the extent that the depositions and documents requested could be obtained under domestic law and practice with respect to domestic taxes.

It is contemplated that the information exchanged under this Article may be on a routine basis, such as reporting on income payments made and tax withheld, or in response to specific requests. The competent authorities may agree on the items of information to be furnished routinely. They may also agree to furnish information spontaneously which they believe to be relevant in applying the Convention or the domestic laws covered by the Convention and to develop and implement other programs of information exchange within the conditions of this Article.

The competent authorities agree to inform each other of materials published in their respective Contracting States which concern the application of this Convention. Such material, including legislation, regulations, rulings or judicial decisions, is to be transmitted in the calendar year following that of publication, or sooner if feasible.

Notwithstanding the provisions of Article 2 (Taxes Covered), the exchange of information provided for in this Article shall apply to all taxes imposed at the national level. Thus, for example, information may be exchanged with respect to estate, inheritance, gift, employment, excise and sales taxes.

## ARTICLE 27

### Diplomatic and Consular Officers

This Article confirms that this Convention does not affect any fiscal privileges afforded

to diplomatic and consular officials under international law or other agreements.

## ARTICLE 28 General Rules of Taxation

Paragraph 1 states the general rule that a Contracting State may tax a resident of the other Contracting State only with respect to income derived from sources in the first-mentioned State. The source rules to be used for this purpose are contained in Article 7 (Source of Income).

Paragraph 2 States the general rule that the Convention is intended to benefit taxpayers and not to make them worse off than they would be in its absence. Thus, a taxpayer may always elect to apply the rules of domestic law or of another agreement between the Contracting States in lieu of the treaty rules. A taxpayer may not, however, make inconsistent choices between the rules of the Code and the rules of the Convention. For example, a taxpayer may not choose to apply the Convention's permanent establishment rules to one U.S. business operation and the Code trade or business rules to another to vary the treatment of profitable and loss operations, but it could apply the trade or business rules to all U.S. business operations and claim the reduced withholding rates under the Convention on U.S. dividends not effectively connected with a U.S. trade or business.

Paragraph 3 provides a "saving clause" which excepts the residents or citizens of a Contracting State from treaty benefits conferred by that States. Each State also preserves its right to tax certain former citizens under domestic law. (The latter provision, which is currently applicable only to the United States, preserves the taxing rules of Internal Revenue Code section 877.) Residence is defined under Article 4 (Fiscal Residence) for all purposes of the Convention, including this provision. Thus, a U.S. resident alien, who under the Convention is determined to be a resident of Indonesia, is a resident of Indonesia for all purposes of the Convention, including the limitations of tax at source provided, for example, in Article 11 (Dividends). A U.S. citizen resident in Indonesia under the Convention generally remains subject to U.S. tax on his worldwide income in accordance with the rules of the Internal Revenue Code.

Paragraph 4 provides certain exceptions to the saving clause of paragraph 3. U.S. residents, as determined under Article 4 (Fiscal Residence), and U.S. citizens are entitled to certain treaty benefits provided by the United States. Those benefits are the right to correlative adjustments of tax provided under paragraph 3 of Article 10 (Related Persons), the exemption from tax at source of alimony and child support payments provided under paragraph 3 of Article 21 (Private Pensions and Annuities), the exemption from tax in the country of residence of social security benefits from the other Contracting State provided in Article 22 (Social Security Payments), the foreign tax credit as provided in Article 23 (Relief from Double Taxation), and the provisions of Articles 24 (Non-discrimination) and 25 (Mutual Agreement Procedure).

Paragraph 4(b) provides that individuals who are not U.S. citizens and are not permanent immigrants to the United States ("green card" holders) are entitled to the treaty benefits granted by the United States to individuals working for or retired from the Indonesian government under Article 18 (Government Service), students and trainees under Article 19 (Students and Trainees),

teachers and researchers under Article 20 (Teachers and Researchers), and diplomatic and consular officers under Article 27 (Diplomatic and Consular Officers). This subparagraph applies only to persons who were residents of Indonesia when they came to the United States but become, under Article 4 of the Convention, residents of the United States. This might happen, for example, in the case of a trainee. The guarantee of treaty benefits provided in this subparagraph has become less important than under the law in effect when this provision was negotiated, because under the definition of residence introduced in section 7701 of the Internal Revenue Code in 1984 such individuals typically will not be considered U.S. residents under U.S. law.

Paragraph 5 confirms that each country may prescribe regulations to carry out the provisions of the Convention. In general, this technical explanation takes the place of regulations with respect to application of the Convention by the United States.

Paragraphs 6 and 7 provide rules to prevent treaty shopping" by persons not intended to benefit from the provisions of the Convention. Paragraph 6 provides that a resident of a Contracting State, other than an individual, may not claim benefits under the Convention unless it meets two conditions. More than 50 percent of the beneficial interest in such person, (or more than 50 percent of the number of shares of each class of Shares in the case of a company) must be owned by any combination of individual U.S. residents and citizens, individual residents of Indonesia, publicly traded companies, and the Governments of the United States and Indonesia. In addition, the income of such person may not be used in substantial part, directly or indirectly, to meet liabilities to persons other than the kinds of persons identified above. The purpose of the second condition is to prevent residents of third countries from setting up a company in a Contracting State which meets the ownership requirements but which pays out a large share of its income through deductible expenses, such as interest and royalties, to third country residents. It is not meant to deny benefits to companies which, for business reasons, purchase supplies from third countries; the focus is on liabilities for interest, royalties and certain compensation, not on the cost of goods sold. This intent is confirmed in paragraph 7 which excepts from the conditions of paragraph 6 companies which are either publicly traded or which have a genuine business purpose and are not established or operated with a principal purpose of obtaining benefits under the Convention.

Paragraph 7 recognizes that a company which is a resident of a Contracting State may be primarily owned by residents of third countries and/or may make substantial deductible payments to residents of third countries in the ordinary course of business. Companies whose residence in a Contracting State does not have a principal purpose obtaining benefits under the Convention, i.e., which are established there for valid business purposes, are entitled to such benefits. Companies whose principal class of shares is regularly traded in substantial volume on a recognized stock exchange are presumed to satisfy this business purpose condition.

Paragraph 8 defines the recognized exchanges for this purpose and authorizes the competent authorities to agree on additional stock exchanges in the future as appropriate. Although the Convention does not preclude agreement on an exchange in a third country, it is anticipated that any additional exchanges agreed upon would be in either the United States or Indonesia.

ARTICLE 29  
Assistance in Collection

Under this Article each country agrees to endeavor to assist the other in collecting the additional tax due when a person not entitled to such benefits obtains an exemption or reduced rate of tax under the treaty. For example, if an individual resident of a country with which the United States does not have an income tax treaty has dividends on his U.S. shares paid to an Indonesian bank on his behalf, Indonesia would attempt to collect the additional 15 percentage points of U.S. tax due on such dividends and remit that sum to the United States. Conversely, the United States would make a similar effort on behalf of Indonesia. As explained in paragraph 2, neither State is obligated to undertake administrative measures inconsistent with its regulations and practices or which would be contrary to its public policy. The usefulness of the type of assistance provided for in this Article depends on the way in which the country of source grants reduced rates under the Convention. It is most relevant if the rate reduction is granted simply on the basis of the recipient's address. It becomes less important if an official certification of residence of the beneficial owner is required, or if the initial tax is imposed at the statutory rate and the excess refunded when the beneficial owner documents his residence.

ARTICLE 30  
Entry into Force

The Convention is subject to ratification. It enters into force one month after the exchange of instruments of ratification, which is to take place in Washington, D.C. The withholding rate reductions provided for in Articles 11 (Dividends), 12 (Interest), and 13 (Royalties) take effect with respect to dividends, interest and royalties paid or credited on or after the first day of the second month after the Convention enters into force. With respect to other taxes, the Convention takes effect with respect to taxable years beginning on or after January 1 of the year in which the Convention enters into force. The reference to calendar years as well as to taxable years was inserted at the request of Indonesia to clarify that the taxable year may differ from the calendar year.

The Convention was ratified by Indonesia on October 31, 1988.

ARTICLE 31  
Termination

The Convention will remain in force indefinitely unless it is terminated by either Contracting State in accordance with this Article. Either State may terminate the Convention after it has been in force for 5 years by giving notice through diplomatic channels at least 6 months in advance. In that event, the Convention will cease to have force and effect for withholding taxes on dividends, interest and royalties paid, and for taxes on other income of taxable years beginning, on or after January 1 next following the expiration of the notice period

of 6 months or more.

## PROTOCOL 1

The Protocol sets forth agreements with respect to the interpretation of these points. Each has been mentioned in connection with the relevant article.

Nothing in this Convention restricts the legal rights of a resident of a Contracting State to pursue claims with respect to the taxation of income from the operation of ships or aircraft in international traffic derived in years prior to the entry into force of the Convention.

The use of facilities in a Contracting State or the maintenance of a stock of goods or merchandise in a Contracting State belonging to a resident of the other State for the purpose of occasional delivery of such goods or merchandise does not constitute a permanent establishment of the resident in the first-mentioned State.

Paragraph 4 of Article 11 (Dividends) permits the United States to tax any excess of interest deducted by the U.S. permanent establishment of a resident of Indonesia over the interest paid by that permanent establishment, in accordance with Section 884 of the Internal Revenue Code, but subject to the limitation that the rate of tax on such "excess interest" may not exceed 15 percent.

## EXCHANGE OF LETTERS

An exchange of side letters confirms the understanding of the two States about the interpretation of the territorial definition of Indonesia contained in Article 3 (General Definitions). It is understood by both States that Indonesia applies the arch pelagic States principles in accordance with the provisions of Part IV of the 1982 United Nations Convention on the Law of the Sea and respects international rights and obligations pertaining to transit of the Indonesian arch pelagic waters in accordance with international law as reflected therein.

## PROTOCOL 2

### TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE PROTOCOL TO THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF INDONESIA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, WITH A RELATED PROTOCOL AND EXCHANGE OF NOTES, SIGNED ON JULY 24, 1996

The Protocol, signed at Jakarta on July 24, 1996, ("the 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

Respect to Taxes on Income, with a related Protocol and exchange of notes, signed on July 11, 1988 ("the Convention").

The technical explanation is an official guide to the Protocol. It does not provide a complete comparison of the Protocol to the Articles of the Convention that it amends.

## ARTICLE 1

Article 1 of the Protocol amends Article 11 (Dividends) of the Convention to reduce the rate of tax that may be imposed at source on dividends and the rate at which branch taxes may be imposed under Article 11

Paragraph 1 of Article 1 of the Protocol amends paragraph 2 of Article 11 of the Convention to reduce in certain cases the rate of tax allowed at source on dividends from 15 percent to 10 percent. The 10-percent rate applies to dividends paid by a company that is a resident of one of the Contracting States if the beneficial owner of the dividends is a company that is a resident of the other Contracting State and the beneficial owner owns directly at least 25 percent of the voting stock of the company paying the dividends. The rate of tax that may be imposed at source on all other dividends remains at 15 percent.

Paragraph 2 of Article 1 of the Protocol amends paragraph 4 of Article 11 of the Convention to reduce from 15 percent to 10 percent the rate of tax that may be imposed under Article 11 on the profits or interest payments allocable to permanent establishments. The limitation applies to both the U S and Indonesian branch profit taxes.

## ARTICLE 2

Article 2 of the Protocol amends Article 2 (Interest) of the Convention to reduce the rate of tax at source on interest and to clarify the treatment of interest paid to the Government or a governmental entity of a Contracting State. Paragraph 2 of Article 12 of the Convention is amended to reduce from 15 percent to 10 percent the rate of tax that may be imposed at source on most categories of interest derived from sources within one Contracting State and beneficially owned by a resident of the other Contracting State.

Article 12 of the Convention is amended to specify what types of governmental entities of a Contracting State would qualify for the exemption from tax at source, provided in paragraph 3, for interest payments to such entities that arise in the other Contracting State. These entities are limited to the Government of each Contracting State, including its political subdivisions and local authorities, the central banks of the Contracting States, and any other financial institution owned or controlled by the Government of a Contracting State. For example, interest payments to the State Bank of Indonesia would qualify for exemption from U.S. tax, and interest payments to any of the Federal Reserve Banks or to the U.S. Export-Import Bank would be exempt from Indonesian tax. At the same time, interest payments to non-financial State owned or State-controlled institutions that are not a part of the Government itself (such as State-owned hospitals,

educational institutions, and industrial concerns) would not qualify for the exemption.

The language of paragraph 3 of Article 12 allows taxation only by the country of residence. This language, which is found in several other Indonesian tax treaties, is equivalent to exemption from tax at source.

#### ARTICLE 3

Article 3 of the Protocol amends Article 13 (Royalties) of the Convention to reduce from 15 percent to 10 percent the rate of tax that may be imposed at source on royalties derived from sources within one of the Contracting States and beneficially owned by a resident of the other Contracting State.

#### ARTICLE 4

Article 4 of the Protocol states that the Protocol is an integral part of the Convention. This statement is included solely for the sake of clarity; the Protocol would be part of the Convention even in the absence of such a statement.

#### ARTICLE 5

Article 5 of the Protocol provides the rules governing the entry into force of the Protocol provisions. The Protocol will be subject to ratification according to the normal procedures in both Contracting States and instruments of ratification will be exchanged as soon as possible. Upon the exchange of instruments, the Protocol will enter into force immediately. The provisions of the Protocol will have effect for amounts paid or credited on or after the first day of the second month following the date on which the Protocol enters into force.