Customs and Tax Consequences of Operating Under the New Contract of Work in Indonesia

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SUMMARY

Indonesian tax and customs law is of major concern to capital investors in the Indonesian mining sector. The mining sector has previously been protected from tax law changes by a doctrine known as "lex specialis". The government of Indonesia is changing the rules in the latest generation of Contracts of Work to eliminate lex specialis, forcing investors to analyse and keep up with internal Indonesian tax and customs law. An analysis of the current rules is presented in the paper.

THE DEVELOPMENT OF "LEX SPECIALIS"

The Contract of Work ("COW") system in Indonesia is a much envied and much imitated model. Its beginnings were in 1967 when my company, then called Freeport Indonesia, signed the first mineral COW with the Government of the Republic of Indonesia (the government).

The terms of the first COW were specifically negotiated, as there was at

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that time no "model" for such an agreement. For readers familiar with the process of negotiating a sixth generation COW, this quote from the negotiators of a first generation COW, Forbes Wilson and Ali Budiardjo, might be entertaining:

> "Ali and I put our heads together and decided that while the existing language in the agreement had been reached only after painstaking compromise, the demanded change [by the government] was of less importance than attaining the goal of a signed agreement. I knew that the company's lawyers would not like the change, but exercising my prerogative as the man on the spot, I took out my pen and made the necessary changes."

Like today's counsel representing companies desiring to enter the Indonesian mining "race", Wilson and Budiardjo were faced with the necessity to "think on their feet" about the consequences of contractual terms that might last for 50 years. They were also often at odds with lawyers and others from the "home office", who wanted specific, favourable and unambiguous terms in the COW document. The comfort level was increased greatly when the government, following advice from Harvard University consultants, decided to balance the interests of the national prerogative to change the law against the desire to attract long–term, capital–intensive projects.

During the first COW negotiation, it was recognised by the government and Freeport that a contract that offered stability was needed, even though there might be a change in government or laws over the long term of a mining agreement. Therefore, the government developed a doctrine known as "lex specialis" or "special law" to describe the relationship of the investor to the government, as embodied in the COW agreement. Under "lex specialis," tax provisions in a COW supersede the internal law of Indonesia, and protect the investor from changes in tax laws over the term of the agreement. The status of the doctrine was "officially" recognised in Art 33A of Tax Law No 9 of 1994, which was approved by the Parliament and signed by President Suharto.[1] The doctrine had been recognised previously by the Minister of Finance and the Director General of Tax insofar as it relates to tax provisions in COWs prior to the new tax law.[2] The rulings made clear that the COW was considered to "be equal" to laws passed by the Parliament, since the COW was approved by a committee of

1. Article 33A(4) states: "Taxpayers engaged in the field of oil and gas mining, general mining and other mining based on a Production Sharing Contract or Contract of Work which are still valid at the effective date of this law shall be subject to tax in accordance with the terms stipulated in the Production Sharing Contract or Contract of Work through the expiry of such contracts and agreements."

2. See Letter of the Minister of Finance, Number S-1032/MK.04/1988, 19 September 1988; Circular of the Director General of Taxation, No SE-14/PJ321/1993, 9 June 1993; Letter of the Minister of Finance, No S-1427/MK01/1992, 25 November 1992. To the author's knowledge, the doctrine has not been officially recognised outside of tax matters, although Mines Department officials acknowledge the "sanctity of contract" principle even where the sovereign is the other contracting party.

Parliament and signed by the President.[3]

LEX SPECIALIS UNDER STRESS

Although the existence of lex specialis as a historical principle is beyond doubt, the concept of lex specialis does not solve all questions related to the interpretation of tax provisions in a COW. Many tax ambiguities exist in current COWs. And, like any contracting party, the Indonesian government interprets ambiguous provisions in its favour. For example, much potential for penalties exists where the payer of an invoice for services fails to withhold the proper amount of income tax from the invoice. However, the withholding rules of the COW conflict directly with the tax law.

How is a company to interpret a COW provision that requires a higher rate of withholding on a services transaction than is expected in a new amended tax law? Many fifth generation COWs state that the COW company must withhold 15 per cent from every invoice from a vendor for technical and management services "for the term of the agreement". Unfortunately, the rate of withholding under general law was reduced in 1991 to 9 per cent and now stands at 6 per cent.[4] If the higher withholding rate is used, the company is a less attractive purchaser of services than one that is not bound by the COW system and can withhold at a lower rate.[5]

The government has also struggled with certain COW provisions that contravene law that is familiar to the officials charged with enforcing it. Although the COW states that English is the governing language, many officials search for "escape clauses" in the Indonesian translation. The English language provisions of a COW might be perfectly clear concerning the non-payment of VAT on all imports, but the Indonesian translation uses a "term of art" referring to internal law. In one recent case, the COW stated that "[imports] shall obtain...full relief from and postponement of value added tax". The Indonesian translation used the term "penundaan" for "postponement", which was a term of art implying that the VAT was only postponed for five years, at the end of which time it needed to be paid back. Some COW companies have for years fought an interpretation that

3. See, for example, Letter of the Minister of Finance No S-1427/MK.01/1992, 25 November 1992: "It is hereby notified that coal mining exploitation co-operation agreements which have been approved by the Parliament and the President ... are valid as/considered equal to laws. Therefore the tax provisions stipulated in coal mining agreements are specifically enforced (that is, based on special treatment/lex specialis)."

4. In a more recent development, the Minister of Finance has decreed that lessors of real property must pay a "final tax" (that is, the rent income is not subject to the marginal rates) of 6 per cent of the gross amount of rental. This kind of a change has a dramatic effect on tax liability depending on the profitability of the lessor. See Decree of the Minister of Finance No 394/KMK.04/1996, 5 June 1996.

5. Although, technically, withholding taxes on services rendered domestically are creditable against a contractor's final tax liability, in practice, most contractors do not have enough net income to absorb high withholdings and therefore are averse to contracts with lex specialis companies who must withhold at high rates.

requires the payment of VAT on the importation of spare parts because of this semantic difference. Changing internal law often conflicts with the "fixed" provisions of a COW, creating a conflict between the government and the COW company.

Some government officials, especially tax auditors, who are unfamiliar with the COW process and the rulings mentioned, continue to maintain that laws enacted after a COW supersede the COW. Some tax officials also contend that the COW is not in fact equivalent to law, because the entire Parliament has not voted on the provisions.

Confusion about the applicability of COW provisions in the face of contradictory tax laws encouraged the Parliament to add Art 33A to the new tax law enacted in 1995.

The Ministry of Finance, for its part, determined to do away with lex specialis in tax provisions in the latest "generation" of COWs.[6] Article 33A of the 1995 Indonesian Tax Law provides that all tax exemptions cease as of 31 December 1994, except for tax provisions in COWs signed prior to 1 January 1995. The Minister of Finance intends to enforce this provision and has stated that there will be no more tax facilities exceeding the facilities as "set forth in the prevailing tax laws".[7] This retreat from lex specialis has important implications for mining investors who are projecting the economics of their projects.

NEW SIXTH GENERATION COW IMPORT TAX RULES

The first tax rules that will be encountered by an investor under the new sixth generation hard rock mining COW or the new coal COW is the Article on "Import and Export Facilities". This Article is either numbered 12 or 13 depending on whether the COW is for coal production or hard rock mining, but the content is virtually identical.

A new investor will of course want to make detailed projections concerning the potential rate of return of a substantial investment in mining, and will quickly realise that a large volume of capital equipment, spare parts, consumables and other materials will need to be imported to

6. The latest "generation" of hard rock mining contracts is called the "sixth generation COW". At the time of writing approximately half of the hard rock mining sixth generation COWs had been initialled before Parliament. While there were about 70 applicants for the sixth generation COW, the newest round seventh generation COW has attracted triple that number (about 240). This has of course encouraged the Indonesian government to "tighten" tax provisions based on demand. However, there is a feeling that many of the new applicants do not intend to invest capital for a mine, but to enhance share value in the short term for their companies.

7. Letter of the Minister of Finance No S-718/MK.04/1995, 5 December 1995 states: "The tax treatment in the said [sixth generation] general mining [COW] has been stipulated in reference to the prevailing provisions pursuant to the relevant tax laws ... Therefore, in such a general mining [COW] there shall be no more tax facilities exceeding the facilities as set forth in the prevailing tax laws."

make the project viable. Most large machines and other mining equipment used in a modem mine are not yet produced in Indonesia. My company, for example, imported almost $500m of goods last year related to mining production, such as ball mills, and I expect that this will be the norm for years to come until such equipment is produced within the country.

Imports into Indonesia can potentially be subject to six different types of taxes: Import Duty ("BM"); Additional Import Duty ("BMT"); VAT ("PPn"); Luxury Tax ("PPnBM"); Income Tax Withholding ("PPh 22"); and Excise.

Import duties have generally been decreasing over the past two years, but are still at a rate that could add a double digit percentage to the front-end capital cost of an import intensive project like a mine, if relief is not extended.[8] The footnote accompanying the text presents some different "tariff headings" form the "non-AFTA" tariff book to illustrate what might be used as a benchmark for making certain financial projections related to imports. A slight decrease is apparent in certain of the averages, but it can be seen that Indonesia still has some rather daunting import barriers for capital intensive projects.

These types of averages should be used with extreme caution, however. First, it is important to note that there is tremendous variation among tariff code headings. The Indonesian tariff book (which follows the international standard "Harmonised System" of categorising imports) lists all tariffs applicable to each of the 9,000 or so categories. For example, one type of explosive might be duty free, while another may have a 30 per cent tariff. For this reason, it is important to know what is being bought or quoted and attempt to link that to a specific "HS" number.[9] A second reason for caution is that different countries have different import rates. Countries that subscribe to the Asian Free Trade Agreement have lower rates on some items than other countries that do not, similar to the North American Free Trade Agreement. A good source for tracking the ever-changing tariff structures is the Indonesia publication, *Business News*, which publishes new tariff rates every two days.

The greatest potential cost is with the two types of import duty and VAT. Taken together, these represent a major cost of investment. Without

8. A recent ad hoc survey by the author of tariff rates current as of January 1996, showed that average tariffs (BM only) on certain selected categories which might be imported by a mining company were as follows:

HS Chapter Number	**Description**	**Average BM - 1/96**	**Average BM - 4/95**
36	Explosives	13.33%	13.00%
72	Iron & Steel	8.13%	8.88%
73	Articles of Iron & Steel	14.91%	15.25%
84	Various Machinery	6.76%	7.70%
85	Electrical Machinery	13.08%	13.76%
87	Vehicles	54.03%	59.57%

Caution should be exercised in applying averages since there is tremendous variation among items in an HS category under a particular tariff heading.

9. It might be good practice in this regard to include standard purchase order clauses that require vendors to furnish HS Codes with their orders.

any sort of an exemption, most capital intensive projects in Indonesia would never get off the ground.

Indonesia has adopted a comprehensive system of exemption from these formidable barriers. Exemptions can be obtained either within the framework of a COW, or outside of it. Both the fifth and sixth generation COWs exempt most imports from import duties. By way of contrast, however, the fifth generation COW exempted all classes of imports from import duties (BM and BMT), except for "foodstuffs, wearing apparel and other vital necessities for the personal needs of the company's employees." This exemption was (and is) qualified by the requirement that a preference in purchasing be extended to domestically produced goods, where such goods are available on a comparable basis. However, in keeping with the trend toward elimination of lex specialis, the sixth generation COW states that "imported items shall be exempt from or eligible for relief from import duties...in accordance with the prevailing regulations". The fifth generation COW simply stated that such items were "exempted from import duties".

The practical difference between the fifth and sixth generation COWs on import duties is that the investor must look to other laws to finds its exemption and not the COW. The scope of the exemption is still being discussed by BKPM and Customs, but it is almost certain that all types of capital goods associated with a project will continue to be exempt from import duties, along with some associated spare parts and certain business consumables up to a limit. The sixth generation COW investor will no longer be able to assume in financial modelling that all "business related" imports are duty free, although with appropriate planning the effective difference between a fifth and sixth generation COW on this point should be relatively small. Without appropriate planning, the financial consequences could be severe.

Since the sixth generation COW will now be reliant on internal law for the all important import exemptions, it is useful to review these in some detail.

The first subject of review is import tariffs themselves. It has been a fundamental policy of the Indonesian government since 1971 to provide import tax relief to industries that "aid in the development of the production sector and protect the consumer". This import tax relief has taken the following form:

1. BKPM can grant exemption from import tariffs for machines, tools, equipment, transportation equipment, such as trucks weighing no less than two tons, and construction materials in the form of iron, steel and aluminium if recommended by the Departments of Public Works and Industry, all up until the time the enterprise begins production.
2. BKPM can grant import tariff relief for "basic/complementary materials" to meet two years' needs of a business, without regard to the time of importation. The apparent meaning of "basic/complementary materials" are materials used and consumed in the production process.

3. BKPM can grant exemption from import tariffs for spare parts as long as the value of these does not exceed 5 per cent of the price of the installed imported equipment base.
4. BKPM can grant a reduction in import tariffs of up to 50 per cent of the published tariff for trucks weighing less than 2 tons, office machinery such as typewriters, calculators and air conditioners, and building fixtures that are not produced.

With respect to other types of taxes on imports, the government has been relatively less generous than with respect to import duties. Up until 1991, BKPM had been extended the authority to grant exemption from withholding tax on imports called "PPh 22". This tax is levied at a rate of 2.5 times the import value. It is creditable against the income tax liability of a company in a particular year. For start up companies, this creditability will not be particularly helpful, because there will be no tax liability. The only alternatives available are to seek a tax refund, which provokes an automatic audit, or to attempt to seek an exemption from the tax office, which is rarely granted. In 1991, the Minister of Finance removed the authority from BKPM to grant this exemption, and the tax applies regardless of the provisions of the COW.

Another potentially expensive tax is VAT on imports. This tax is levied at a rate of 10 per cent on all imports, unless deferred. It is refundable if the tax is related to the mining company's primary business, but is not refundable except once per year at the end of a year prior to the commencement of production.[10] Under the fifth generation COW, the COW holder obtained "full relief" from VAT with respect to all categories of imports (including VAT on spare parts and consumables), except for certain employee-related items. As with import duties, the new sixth generation COW limits the "relief" to that available under existing law for deferring the VAT.[11]

Like import duties, only certain items are eligible for VAT deferral under the general law, not including spare parts or consumables.[12] The absence of import duty or VAT deferral for spare parts can be illustrated by this example:

10. Article 9(10) of Tax Law No 11/1994 states: "If at the end of the book year there is an excess of Input Tax ... the said excess Input Tax may be requested for a refund."
11. BKPM and the tax authorities use two words to describe VAT deferral. One is "penundaan", which implies that the VAT will be postponed for five years and then repaid. The other is "penangguhan", which implies a permanent deferral. BKPM has so far stated that the VAT deferral on certain items (not including the bulk of spare parts and consumables as noted) can theoretically be granted until 2001. However, this deferral runs counter to Art 33A of the new VAT law, which states: "The postponement of payment of the Value Added Tax and Sales Tax on Luxury Goods granted prior to the enforcement of this law shall end in accordance with the period of postponement granted, the latest by December 31, 1999." The question of whether all VAT deferral facilities cease as of 30 December 1999 is open, as is the issue of whether VAT that has been deferred must be repaid at that time. Some commentators have suggested that deferred VAT must be repaid or offset by that time. See Leonard van Hien, "Tax Changes, Deregulation Create Investment Boom in Indonesia, International Taxation" February 1996.
12. Decree of the Minister of Finance No 577/KMK.00/1989, 29 May 1989.

- import of one lot of tyres for motor cars (HS Number 401310000) at a cost of $100,000;
- import duty is 30 per cent, or $30,000, which is not exempt because tyres are "spare parts";
- VAT is 10 per cent or $10,000, VAT would be refundable at the end of a year during start-up;
- PPh 22 is 2.5 per cent or $2,500, PPh 22 is refundable if no tax to soak up, but refund requires audit and 18-24 months to obtain; and
- total cost is $142,500 for tyres with a cost of $100,000.

In the example, it can be seen that this imported lot of tyres either is not eligible for exemption under the rules, or has exceeded the 5 per cent limitation. In this case, the tyre experiences a 30 per cent import duty, 10 per cent VAT and 2.5 per cent PPh 22, which increases the cost for the lot to $142,500 from $100,000, a 42.5 per cent increase. The VAT would eventually be refundable but since it can take up to 18 months to process the paperwork, an appropriate time value of money factor would need to be added to estimate the actual "true" cost.[13] The same applies to the PPh 22 that would be due. In a start-up project, the company may not be able to credit the PPh 22 and will therefore be forced to apply for a refund after experience an audit. It is estimated that this process can take up to two years to complete.

This may be a particularly appropriate example, because it is often said, in the hard rock mining industry at least, that the cost of spares for large machines is often 300 per cent or more of the purchase price for the original equipment over the useful life of the equipment.

A company that is forced to import under this scenario does have some alternatives. First, it could seek an exemption from PPh 22 from the tax office to lower the cost somewhat. These exemptions are rarely granted however, and substantial support needs to be provided for the proposition that the taxpayer will not be in a taxable position for the year in which the PPh 22 is remitted. Secondly, with respect to VAT, there is a provision in the new tax law (Article 16B of Law No 10) that allows VAT to be exempted in remote areas by government regulation. It is unknown how this regulation is to be applied. However, an initiative to exempt VAT in certain remote areas was recently announced by Ministers Habibie and Sanyoto and may be applied within a few months in certain specific areas, which may fall within some COWs.[14] In addition, careful attention paid to

13 The Tax Office has also taken the position that VAT refunds may be "attached" by the government if there is any outstanding tax dispute. A recent case involved a mining company which was assessed VAT on deliveries of mineral *to the government* under a Production Sharing Arrangement. Despite the clear absence of a basis for such a position, the Tax Office has suspended refund processing for the company related to VAT that would ordinarily become refundable. The government also has new administrative rules under consideration that would prohibit the appeal of tax disputes to the Indonesian Tax Court until disputed liabilities were paid in full.

14. The proposed relief is part of an incentive package offered to investors in the Eastern provinces. Minister Habibie is the head of an intergovernmental task force called the "Dewan KTI" or "Development Council for the Eastern Provinces". The decisions of this

the paperwork required to obtain VAT refunds could reduce the time period between the payment and the refund.

Another hopeful sign is that the government is aware of the problems that could be faced by investors due to a lack of exemptions from these significant import barriers. The relief under general law for VAT at least was almost eliminated in total in 1995 in accordance with the new tax law. However, the government took a pragmatic approach and promulgated a "grandfathering rule" that extended the exemption for companies that obtained a BKPM investment license before 1 January 1995, as long as all goods covered by the VAT exemption facility were imported within three years after the investment license was granted.[15] The government further softened this rule to cover all BKPM licensees up to 31 March 1998, as long as import realisation is made within three years after the granting of the license.[16]

Thus, the theoretical limit for VAT exemption, 2001, is approximately the time that import barriers begin to fall under GATT, AFTA and other multilateral agreements. A word of caution is appropriate here as well. Article 33A of the new VAT law states that the "postponement of payment of the Value Added Tax and Sales Tax on Luxury Goods granted prior to the enforcement of this law shall end in accordance with the period of postponement granted, the latest by December 31, 1999". The question of whether all VAT deferral facilities cease as of 30 December 1999 is open, as is the issue of whether VAT that has been deferred must be repaid at that time. A final imponderable is that the government is currently working on a new package of general tax incentives that can be granted by BKPM, which may completely change the analysis presented above.

Companies that have recently signed sixth generation COWs or the new coal would therefore be advised to do the following when planning construction projects that involve imports:

- make sure the investment model incorporates the cost of import duties and VAT on certain imports;
- make sure the BKPM investment license application requests the maximum available deferral or exemption from import duties and VAT available under general law; and
- make sure that staff charged with purchasing and importing factor in potential import duties and VAT when making an "import versus local" purchase decision.

task force will have a major effect on the economics of some projects, and investors would be well advised to watch for developments from it over the coming months.

15. See Letter of the Director General of Taxation, No S-434/PJ.5/1995, 4 April 1995 and Circular of the State Minister for Investment, No 386/A.1/1995, 11 May 1995.

16. See Circular Letter of the State Minister for Investment on behalf of the Minister of Finance, No 327/A.1/1996, 1 April 1996.

INCOME TAX AND VAT RULES IN THE NEW COW

Rate reduction

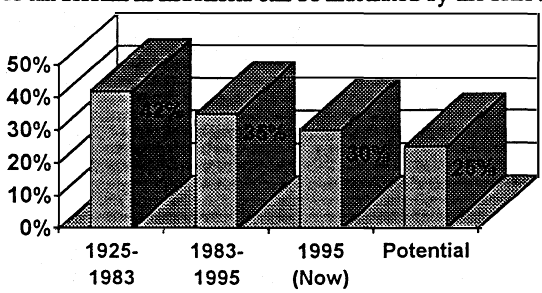
While the new COW rules on imports may give some investors some pause, and some homework to do, many of the new income tax provisions are very welcome. At the top of the list, of course, is the reduction in the top corporate income tax rate from 35 per cent to 30 per cent.[17] Here again, the government took a pragmatic approach. Early drafts of the COW suggested that the government would attempt to tie the top rate of tax to whatever rate was in effect in Indonesia at the time. The final draft, however, is quite clear that the top rate is 30 per cent for the duration of the COW, which may even be further reduced to 25 per cent by government regulation. The new mineral and coal COWs both state that the tax rates to be charged for the duration of the agreement are between 10 and 30 per cent. Article 17(2) of the new corporate tax law states that "by government regulation, the highest tax rate ... may be reduced to a minimum of 25 per cent".[18]

It should be pointed out that lex specialis has worked as a "sword" for the government with respect to older COWs. The top rate remains at 35 per cent or higher for COWs signed before the new tax law came into effect.

Equally important to investors is the reduction in dividend withholding rates. The new hard rock mining COWs provide that the withholding rate on the distribution of dividends to a foreign "founder" shareholder is reduced to 7.5 per cent. This was an unexpected change and causes the rate of dividend withholding to be lower than most tax treaty rates.[19] The latest draft of the coal COW does not contain this beneficial language on dividends and instead refers to tax treaties to reduce dividend withholding rates. It is not known at this time whether this tax provision of the coal

17. Investors under fifth generation and earlier COWs are still subject to a top corporate income tax rate of 35 per cent.

18. The history of tax reform in Indonesia can be illustrated by the following graph:



19. Such a reduction is contemplated by the new tax law. Art 31A, which states that "[T]axpayers who invest in certain fields of business ... may be granted tax incentives which are stipulated by government regulation." The Elucidation to this Article limits the possible incentives that may be granted, but specifically mentions reduction of the withholding rate on distributions of dividends to non-resident shareholders.

COW, and all the tax provisions will ultimately be harmonised with the hard rock mining COWs.

Taken together, the new income tax rate and dividend withholding rate causes the "effective rate" of tax to a foreign shareholder on the PT mining company's earnings to fall to 35.25 per cent, and potentially even to 30.625 per cent, if a government regulation reduces the top corporate tax rate. Under the fifth generation COW, the effective rate is 48 per cent (reduced by some tax treaties to either 44.75 per cent or 41.5 per cent, depending on the nationality of the foreign shareholder).[20] These changes will certainly encourage investors.

Withholding taxes

While the reduction in rates is certainly good news for investors, it should be pointed out that a shrinking portion of the government's tax revenue comes from corporate taxes on income. The remainder is made up of withholding taxes and VAT that apply to virtually every transaction between businesses and individuals that involves an invoice. In fact, the largest mining company in Indonesia, which paid over $445m in total taxes from 1990-1995, ascribed less than half that total to corporate income taxes.

Withholding taxes make up a large portion of non-corporate income taxes for the government. A withholding tax varying in rates from 1.25 per cent to 20 per cent applies to virtually every transaction between the mining company and its subcontractors, shareholders, banks and other stakeholders.[21] While the economic burden of this withholding does not fall on the mining company directly since the withholding is deducted from the payee's invoice, it is often found that subcontractors will quote either "net of tax rates" or raise gross rates to compensate for the withholding. It often does not help to explain to payees that the tax is creditable, either in their foreign country, or against Indonesian income tax liabilities. Many contractors are in either an excess foreign tax credit position in their home countries, or do not have sufficient Indonesian taxable income to offset

20. The new effective corporate tax rate mechanism can be illustrated as follows:

	5th Generation	5th Generation with US Treaty	6th Generation
Taxable Income	$1,000,000	$1,000,000	$1,000,000
Corporate Tax Rate	35%	35%	30%
Corporate Tax	$350,000	$350,000	$300,000
Distributable Dividend	$650,000	$650,000	$700,000
Withholding Tax Rate	20%	15%	7.50%
Withholding Tax	$130,000	$97,500	$52,500
Net to Shareholder	$520,000	$552,500	$647,500
Effective Rate	48%	44.75%	35.25%

21. Decision of the Director General of Tax, No KEP-10/PJ/1995, 31 January 1995; Decision of the Director General of Tax, No KEP-76/PJ/1995, 2 October 1995.

withholdings made on domestic services rendered.[22]

To mitigate the effect of this withholding, double tax treaties between Indonesia and other countries generally reduce the rate of withholding on payments of dividends, interest and royalties. The withholding rate may be reduced to zero in the case of payments to service contractors, providing that the contractor does not have a "permanent establishment" in Indonesia, and has furnished the payer and the PMA tax office where the payer is located with a "Certificate of Fiscal Residency".

A recent trend in Indonesia has been to substitute withholding taxes on transactions for the "self assessment" system of income tax payments. It is becoming more common to see "final taxes" on gross income substituted for taxes on net taxable income (offset by withholding taxes). Rents and sales of real property in Indonesia are both subject to such "final" taxes. These types of exactions can raise questions about creditability in foreign countries that only allow credits for "income" taxes.

Voluntary taxes

Another recent trend has been in the area of "special voluntary taxes". A recent Presidential Decree asked taxpayers to remit 2 per cent of their financial net income as a "voluntary payment" for the alleviation of poverty. While "voluntary," the Director General of Tax has sent both individual and corporate taxpayers "reminder" letters. It remains to be seen what sanctions will apply to those businesses that do not comply. It does not appear that the doctrine of lex specialis provides any protection from this potential exaction. Any "tax" paid under this provision will certainly be non-creditable in a foreign shareholder's country because it is normally "voluntary".

VAT

In addition to withholding taxes, virtually every domestic transaction involving an invoice will require VAT to be paid. All mining companies are what are known as "VAT collectors" ("WAPU"). This means that 10 per cent VAT will be due on almost every domestic purchase of goods or services, and the mining company will be required to remit the VAT directly to the government. VAT is also payable on foreign services transactions, even where the service provider is a non-resident and performs the services wholly outside of Indonesia, under an interpretation by the Tax Office.

Most VAT is refundable, but the processof refund is often time-consuming, and up to 18 months may be required to receive funds due. In addition, as with the withholding tax, many vendors will ask for "gross ups" on VAT due on their invoices. This is because the WAPU VAT,

22. Although it is theoretically possible to obtain income tax refunds due to overwithholding, in practice such refunds are difficult and time consuming to obtain.

unlike the normal situation, is not paid to the vendor to help her or him offset VAT he or she has paid to subcontractors, but goes direct to the government.

Withholding taxes and VAT definitely have an offsetting effect on the reduction in corporate taxes. However, if strict attention to detail is maintained, the taxes can be manageable. In addition, the Director General of Taxes has recently begun to issue rulings that ease the regulatory burdens and provide certainty.

The new COW investor will need to pay close attention to withholding and VAT rules. Under the previous tax law, penalties for failure to withhold taxes or pay VAT were subject to relatively light penalties, which generally did not exceed 48 per cent of the tax unremitted. The new tax law prescribes penalties of over 100 per cent of the tax for these kinds of infractions.

Companies that have recently signed sixth generation COWs or the new coal COW would therefore be advised to consider the following in connection with income, VAT and other taxes in Indonesia:

1. Hire competent professional advisers to assist in tax return preparation. The penalties for even minor infractions, such as failing to withhold, are severe.
2. Review contracts with subcontractors carefully, especially if drafted by the subcontractor. Often subcontractors will attempt to be paid on a "net of tax" basis, which increases mining company costs.
3. Make sure that investment models take into account non-corporate income taxes such as VAT and withholding taxes. These taxes, even if they are refundable, may have a significant time value of money cost.

CONCLUSION

The mining investment climate in Indonesia has recently attracted significant investor interest. However, mining investors face a very complicated set of rules to follow in terms of corporate law, investment licensing, tax, customs, environmental permitting and other requirements. The successful investor will do well to pay as much attention to the financial and legal intricacies as is paid to engineering work. In doing so, the investor will both win the trust of the officials charged with enforcing the law, and optimise r investment within the scope of the law.