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How Countries in European Union has Solved Problem of Tax Avoidance and Collection of Cross-border Transaction in an integrated Common Market Tax Area. Optimizing Tax Collection in Indonesia, Lessons from European Union's Recovery of Collection Directive, Automatic Exchange Directive, and Savings Directive

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Abstract

The basic concept of capital flight regarding how easy capital can move in cross-border transactions of Adam Smith is one of the groundwork of this thesis. It cannot be denied that both developed countries and developing countries are facing the same problems regarding capital flight. However, European Union (EU) countries have been moving several steps further concerning cross-border transactions. Countries in EU has reached certain minimum standard of law enforcement in addressing Double Taxation problem within EU by helping each other through the recovery of tax claim directive, automatic exchange directive, and savings directive.

This thesis will discuss the established EU directives regarding double taxation and double non-taxation issues in cross-border transactions compared to relatively-new Indonesian regulation in the same area. The idea is to highlight items that can be learned from the legal framework of EU directives to improve Indonesian tax collection system. Among many aspects of variety of taxes, the thesis will focus on direct taxes, particularly cross-border transactions.

The main issue here is the scope of Indonesian's tax regulation regarding cross-border transactions which is not as comprehensive as EU directives. The current Indonesian's tax regulation cannot capture the urgency of automatic exchange of information between national tax authorities and other countries' tax authorities. The issue of revealing bank secrecy related to tax is also a hinder for the identification of taxpayer's condition which makes the exchange of information become difficult.

List of Abbreviations

APA	Advance Pricing Agreement
ASEAN	Association of Southeast Asian Nations
CEN	Capital Export Neutrality
CIN	Capital Import Neutrality
CFC	Controlled Foreign Company
DGT	Directorate General of Taxation
DTC	Double Tax Convention
EEC	European Economic Community
EU	European Union
FATCA	Foreign Accounts Tax Compliance Act
FDI	Foreign Direct Investment
FFI	Foreign Financial Institutions
GAARs	General Anti Avoidance Rules
GDP	Gross Domestic Product
G20	Group of Twenty
IGA	Intergovernmental Agreements
IMF	International Monetary Fund
IRS	Internal Revenue Service
OECD	Organization for Economic Co-operation and Development
MAP	Mutual Agreement Procedure
MTC	Model Tax Convention
p.	Page
TIEAs	Tax Information Exchange Agreements
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
US	United States

1. Introduction

1.1 International Capital Flight

The phenomenon of international juridical double taxation can be generally defined as "*The imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods*."[1] This phenomenon takes places when there is transaction that involves more than one country or in other word 'cross-border transaction'.

Cross-border transactions between countries require a Double Tax Treaty that produces a balanced allocation of taxing power between countries and ensures national tax sovereignty is not compromised. Adam Smith had a view that the nature of capital will opt to "abandon any country if the need arose". This is what encourages every country to be engaged in agreement with other countries, to prevent the risk of losing the ability to tax that may resulting in compromised tax sovereignty.

"*The paradox is that international capital in fact does not flow to poorer countries, because tax advantages are unable to compensate for all other disadvantages (lack of infrastructure, etc.), related to the investment in such countries. The outcome is that poorer countries still end up in having limited fiscal capacity, which prevents them from disposing over revenue to fund their infrastructure and policies for economic development. Alternatively, such countries are obliged to search for revenue by taxing non-mobile persons, who often are striving to survive and have little or no ability to pay.*"[2]

1.2 Background

In EU, Member States have the right to conclude tax treaties with other Member States, as well as with non-Member States. Organization for Economic Cooperation and Development (OECD) plays an important role in in constructing Tax Treaties to the Member States of EU since most of OECD Member States are also EU Member States. As Pistone stated "*OECD member countries usually have strong tax treaty negotiating powers, due to their own international prestige, economic power, or proximity to the average needs of a powerful block of countries with similar international tax policy goals, and this power usually allows them to impose their tax treaty provisions in their tax treaties*".[3] Contrast to OECD Member States, developing countries show the opposite. The weak negotiation power due to poverty, low rate of economic growth and development, can affect tax treaty policy in developing countries. Instead of preventing double taxation by allocating taxing powers fairly, developing countries ended up on lowering effective tax rate, giving relief, and interfering the national tax policies.

As mentioned earlier, OECD Member States usually have a strong tax treaty negotiating power, and whenever they may engage in a Model Tax Convention

[1] Organization for Economic Cooperation and Development, Report of The OECD Committee on Fiscal Affairs, Model Double Taxation Convention on Income and On Capital (1977)
[2] Pasquale Pistone, *Tax Treaties: Building Bridges between Law and Economics,* IBFD, (2010) 419
[3] Pasquale Pistone, *Tax Treaties: Building Bridges between Law and Economics,* IBFD, (2010) 414

(MTC), the OECD Member State may have a contribution in shaping the MTC. By contrast, the developing countries which are 'generally poorer' than their counterparts, will likely choose to grant tax concessions to other contracting states in order to attract Foreign Direct Investment. The stronger contracting state in the tax treaty (in this case OECD Member States) has strong influence to exercise the negotiating power to reach their goal, which is "to impose their tax treaty provisions in their tax treaties."[4] And the developing countries may suffer the weak protection of their international tax policy needs. The situation of developing countries is getting worse when they are engaged into a tax treaty and it is not limited to tax treaties conducted with OECD Member States, but with any country that has better economic situation and strong negotiating power. This scenario describes how two countries with different condition can lead to different outcome from the same treaty.

In particular, even though tax treaties can bring different effect in relation to which country is engaged on the bilateral tax treaty, tax treaty would still be the instrument for OECD Member States to "*make it possible to obtain all relevant information that is needed in order to achieve a correct levy of taxes*"[5] and tax treaty is also the instrument that can be used to exercise the taxing powers and protect the need of developing countries to collect the revenue.

1.3 Purpose

Based on the difference in effect brought by the tax treaty regarding developing country's weak negotiation power, it is important for the author to learn from European Union countries, on how to overcome double taxation and double non taxation phenomenon by engaging in tax treaty since this will make the collection of revenue possible without improperly overburdening the worker and attract foreign investment by giving inappropriate and unfair relief to foreign direct investment.

It is necessary to learn from EU member states because EU have been through a process of transformation starting from the European Economic Community (EEC) and it has been one of the prominent metamorphoses in the modern times.[6] Referring to the Neo-functionalist theory, "today's EU is an altogether different, quasi-constitutional, federal-entity"[7] EU also has deep and broad capacity of creating, interpreting and enforcing rules which resulting in a "supranational governance"[8] and the capacity has been steadily upgraded and producing a denser and more articulated rules which is able to cover and expanding range of substantive domains. The amplification of supranational governance in the EU has been considered as "one of the most remarkable political innovations in the world in the past half-century and a social science puzzle of the first order."[9]

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[4] Pasquale Pistone, *Tax Treaties: Building Bridges between Law and Economics,* IBFD, (2010) 414
[5] Pasquale Pistone, *Tax Treaties: Building Bridges between Law and Economics,* IBFD, (2010) 429
[6] Weiler in Stone Sweet, Alec and Sandholtz, Wayne, *Neofunctionalism and Supranational Governance,* (April 6, 2010), Available at SSRN: http://ssrn.com/abstract=1585123
[7] Burley and Mattli in Stone Sweet, Alec and Sandholtz, Wayne, *Neofunctionalism and Supranational Governance,* (April 6, 2010), Available at SSRN: http://ssrn.com/abstract=1585123
[8] Stone Sweet, Alec and Sandholtz, Wayne, *Neofunctionalism and Supranational Governance,* (April 6, 2010), Available at SSRN: http://ssrn.com/abstract=1585123
[9] Stone Sweet, Alec and Sandholtz, Wayne, *Neofunctionalism and Supranational Governance,* (April 6, 2010), Available at SSRN: http://ssrn.com/abstract=1585123

Indonesia is a developing country that is actively engaged in treaty negotiation. Taxpayers in Indonesia are subject to taxation on their worldwide income. It means that tax authority may impose tax on income that takes place outside the territory of Indonesia. However, there is no right arising for the tax administrators to exercise their power outside the territory of its state. Therefore, there will be no guarantee for a state with the World Wide Income principle that the tax paid on income that takes place outside the country has been taxed appropriately.

The purpose of this thesis is to describe Indonesian national tax law issue and how to address the problem of double taxation and double non-taxation that will likely arise in cross-border transactions in general by learning from countries in European Union addressing the same issue, given that Indonesia as a developing country has its own challenges which are potentially become impediment for the government to improve and optimize the tax collection system.

1.4 Method and materials

The method utilized in the thesis is comparative legal research in which the author will analyze the legal frameworks of recovery of collection directive, automatic exchange directive and savings directive in EU and mutual agreement procedure in Indonesia.

Due to the complexity of understanding the rules, several secondary sources have been also utilized. The materials used have been mainly doctrinal articles and literature, which are mainly in English. The author have studied and examined both international and domestic source, due to the urgency of describing the figure in Indonesia's, there are some references to several Indonesia's institutions which have been crucial in describing Indonesian's domestic tax law. Additionally, I have also utilized a Swedish database which is lagen.nu in order to access Swedish primary law, nonetheless, the information obtained has been supported with secondary source database which is IBFD in order to make it understandable by non-Swedish readers.

1.5 Delimitation

In consideration of the wide scope of cross-border transactions, this thesis will be subject to several delimitations.

Firstly, the focus on the thesis won't be specifically concerning one particular cross-border transaction. Moreover, the thesis will provide a general description of current Indonesian's regulation which is dealing with cross-border transaction and how the elements of the regulation does not have clear concept of defining tax activities related to cross-border transaction and creates loopholes for the taxpayers to conduct tax avoidance or worse, tax evasion. On the contrary, EU context of mutual agreement procedure requires specific definition of each activities, or if it is not specified, EU context sets delimitation that could force one transaction to be taxed somewhere.

Furthermore, among several types of tax treaties including unilateral tax treaties, bilateral tax treaties, and multilateral tax treaties, only bilateral tax treaties will be analyzed.

1.6 Outline

This thesis has been divided into different sections which will further explains different aspects related to cross-border transaction and Double Tax Convention (DTC) in EU countries and in developing countries especially Indonesia. This outline will provide short introduction to every chapter in this thesis in order to give guidance for the reader.

The first chapter will provide background, purpose and aim of the thesis. The second chapter will explain cross-border transactions and double tax treaties in general as a tool which commonly used between countries to coordinate the exercise of taxing rights. Chapter three stands as a starting point to illustrate what are the issues that will likely arise in developing country's when it comes to cross-border transactions in accordance to the effort made by Indonesia to attract foreign direct investment.

The fourth chapter gives further explanation on methods to eliminate double taxation that are utilized by EU, Indonesian, and other countries. This chapter will comprehensively explain the savings directive, automatic exchange directives, and the recovery of collection directive. Finally, the fifth chapter which is the last chapter will highlight several aspects in Indonesian regulation that needs improvement that can be learned from EU.

2. Cross-border Transaction

2.1 A Note on Terminology[10]

Several national tax systems make a difference between tax evasion which involves a taxpayer who escapes from tax liability that has already arisen (criminal matter), and the avoidance of tax liability that have not otherwise arisen (not a criminal matter, however, might potentially resulting in tax penalty).[11] Tax evasion involves, for example mis-reporting of income tax return, which is considered as a fraud. Even though not all tax systems clearly distinct this matter, it is preferable to comprehend that tax fraud involves criminal conduct, while tax avoidance might be unacceptable, but does not involve criminal conduct.[12]

Several tax treaties are aimed to '*the avoidance of double taxation and the prevention of fiscal evasion'*.[13] While in reality, the exchange of information provisions in tax treaties are generally used to counter tax avoidance rather than tax evasion, on the other hand, Mutual Legal Assistance convention relating to co-operation in criminal matters is used more as a basis for administrative assistance in the investigation and prosecution of criminal offences.[14]

2.2 Tax Evasion and Tax Avoidance

There are several forms of tax evasion and tax avoidance in cross-border transactions. The OECD Report of *International Tax Avoidance and Evasion* stated that: "Tax Avoidance (…) is of concern to governments because such practices are contrary to fiscal equity, have serious budgetary effects and distort international competition and capital flows."[15] And on its report in 1987, OECD stated tax evasion as "an action by the taxpayer which entails breaking the law and which moreover can be shown to have been taken with the intention of escaping payment of tax."[16] Or in other words, a definition of tax evasion is: "*The taxpayer avoids the payment of tax without avoiding*

[10] Philip Baker, *Improper use of Tax Treaties, Tax Avoidance and Tax Evasion,* in in United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries, (2013), p. 385 - 387

[11] Philip Baker, *Improper use of Tax Treaties, Tax Avoidance and Tax Evasion,* in in United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries, (2013), p. 385

[12] Philip Baker, *Improper use of Tax Treaties, Tax Avoidance and Tax Evasion,* in in United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries, (2013), p. 385-386

[13] Philip Baker, *Improper use of Tax Treaties, Tax Avoidance and Tax Evasion,* in in United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries, (2013), p. 386, *see also* Title to the United Nations Model Convention, footnote 7

[14] Philip Baker, *Improper use of Tax Treaties, Tax Avoidance and Tax Evasion,* in in United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries, (2013), p. 386

[15] OECD Report on International Tax Avoidance and Evasion, para. 10

[16] Chris Finnerty, Paulus Merks, Mario Petriccione, Raffaele Russo, *Fundamentals of International Tax Planning,* (2007), IBFD Publications BV, p. 49

the tax liability, so that he escapes the payment of tax that is unquestionably due according to the law of the taxing jurisdiction and even breaks the letter of the law."[17]

However, tax avoidance usually comes in the form of profit shifting. The scheme generally occurs by shifting profits to lower-tax jurisdictions and deductible costs to high-tax jurisdictions. The other forms of tax avoidance are allocating debt and earnings stripping. With this method, intercompany lends and borrows to allocate costs and profits. In the case of company in a low-tax jurisdiction lends money to a group company in a high-tax jurisdiction, this will constitute the low-tax jurisdiction to impose tax on the interest, and deductible costs will be recognized in high-tax jurisdiction, which resulting in benefits for the company from the difference in taxation. The next method that is done by the company is transfer pricing on sales of goods and services between group companies. In low-tax jurisdictions, the group companies will increase the price, while it will lower the price on high-tax jurisdictions, thus, profits can be shifted. For tax purposes related to intercompany sales, the same price will be charged to unrelated-parties to comply with arms-length principle. However, when there is no third-party sale, in order to encourage fair intercompany price, the company will use the price of similar goods or a cost plus industry average profit markup, although this method will be challenging to do in new intangibles. The other form of tax avoidance is using hybrid instruments which is created to avoid tax by being treated as debt in one jurisdiction and equity in another, for example an entity that is considered as a corporation in one jurisdiction but recognized as a partnership in another jurisdiction for tax purposes to achieve the benefit resulting from different treatment in different jurisdiction.[18]

From the previous explanation, it can be seen that the difficulty is not about defining tax evasion, it is about drawing a line between tax avoidance and tax planning. The starting point to determine which one is tax avoidance and tax planning is principle pf freedom of contract, which says "taxpayers are free to arrange their affairs as they wish in order to save taxes"[19] The other principle to be taken into consideration is principle of legal certainty, which provides a condition when a taxpayer legally entering a transaction, they should be able to trust that transaction, and the tax authorities and the court should also respect the transaction.

2.3 Solution : National Anti Avoidance Rules And Bilateral Tax Treaties

Tax evasion and tax avoidance are impediments for a government that causing a country lost its revenue from tax. Most of the countries have several measures to combat tax evasion and tax avoidance, it can be done through unilateral, bilateral, or multilateral measures. Unilateral measure that may prevent the tax avoidance are national General Anti-Avoidance Rules **(**GAARs).[20] "General anti-avoidance rules are domestic rules that allow the tax authorities to re-characterize a transaction or a series

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[17] Chris Finnerty, Paulus Merks, Mario Petriccione, Raffaele Russo, *Fundamentals of International Tax Planning,* (2007), IBFD Publications BV, p. 50

[18] Robert F. van Brederode, 'A Normative Evaluation of Tax Law Enforcement: Legislative and Political Responses to Tax Avoidance and Evasion' (2014) 42 *Intertax,* Issue 12, p. 769

[19] Chris Finnerty, Paulus Merks, Mario Petriccione, Raffaele Russo, *Fundamentals of International Tax Planning,* (2007), IBFD Publications BV, p. 52

[20] Michael Lang; Peter Melz; and Eleonor Kristoffersson, *Value Added Tax and Direct Taxation – Similarities and Differences,* (2009), IBFD, p. 1137

of transactions that have been entered with the (sole or main) purpose of obtaining undue tax benefits. Many domestic tax systems contain such rules, either in the form of an express provision incorporated into the tax code or in the form of a general principle of abuse of law, generally developed by local judges in domestic case law."[21] Before GAARs was introduced, unilateral measure to avoid double taxation was done by one of the states involved in cross-border transaction which was withdrawing its tax claim, and the other form was through the allowance of exemptions, for example by exempting foreign income if that income was already taxed in source country. The coverage area of general anti-avoidance is different from one jurisdiction to other jurisdiction, and it also depends on whether in one jurisdiction there will be tax benefit obtained, and that the loss of tax revenue could affect business in other contracting states. These differences constitute three considerations for companies in evaluating the risk of establishing business in other country to minimize the tax burden.[22]

However, those forms of unilateral measures are considered insufficient to avoid double taxation because they were not able to cover the whole issues that arise prior to cross-border transactions.[23] In European Union, GAARs is recommended to be adopted domestically by the EU Member States to combat tax avoidance in domestic and cross-border transactions with other Member States or transaction involving third countries. There are many forms of domestic anti-avoidance rules regarding taxation in European Union countries. For example, United Kingdom has Thin Cap rules and Controlled Foreign Company rules (CFC Rules) which goal is to prevent artificial arrangements in cross-border transactions. CFC rules targets one form of act in avoiding tax by using fictitious arrangements where a company establishing a business without genuine economic activity in other Member State. While United Kingdom has specific category of anti-avoidance rules, Sweden has its GAARs which is more general in addition to CFC and transfer pricing rules. According to the extraction of Sweden's anti-avoidance rules, a transaction that is deemed as an act of tax avoidance may be eliminated if following conditions are fulfilled:

1. "*The transaction results in a significant tax benefit for the taxpayer;*
2. *The taxpayer is, directly or indirectly, a party to the transaction;*
3. *Such a tax benefit is assumed to have been the predominant reason for the transaction; and*
4. *Taxation on the basis of the transaction would be in violation of the purposes of law"*[24]

2.4 National Measures To Guarantee Tax Collection Are Limited

On 26 October 2005, The Commission of The European Communities issued Communication regarding coordination between Member States' direct tax system in the Internal market, where It stated that direct tax system remain in the competence of

[21] Chris Finnerty, Paulus Merks, Mario Petriccione, Raffaele Russo, *Fundamentals of International Tax Planning,* (2007), IBFD Publications BV, p. 207
[22] Chris Finnerty, Paulus Merks, Mario Petriccione, Raffaele Russo, *Fundamentals of International Tax Planning,* (2007), IBFD Publications BV, p. 208
[23] Klaus Vogel, *Double Tax Treaties and Their Interpretation,* (1986), Berkeley Journal of International Law Volume 4 Issue 1 Spring, p. 9
[24] Lag Mot Skatteflykt (SFS 1995:575), translation provided by IBFD, Laura Ambagtsheer-Pakarinen, *Sweden – Corporate Taxation,* IBFD, (2015)

Member States in order to meet its domestic policy objectives. However, national tax law might create unequal treatment in cross-border transaction and also double taxation, which might lead to be obstacle of the Internal Market in EU. Therefore, these problems can be addressed by bilateral tax treaties to overcome the obstacles that cannot be solved by unilateral measure. The Commission believes that mismatches between Member States' tax system which could lead to double taxation and double non taxation due to lack of co-ordination, can be fixed by appropriate co-ordination and co-operation between Member States to meet their tax policy goals and protect their tax revenue and prevent double taxation or double non taxation.[25]

2.5 The Complexities of Cross-border Transactions

Dealing with cross border transaction may present obstacles to contracting parties. The author has mentioned that European Union Member States have strong negotiation power, and they even have the influence to shape the MTC. However, there are challenges that even EU Member States have to encounter, for instance language barriers causing every country that has entered into an agreement with other country who uses different language need to hire a skillful translator, not only it is a costly expense, it also not necessarily guarantee the translator is able to sufficiently provide the actual meaning and purpose of a regulation. The difference in legal systems, tax regimes, and accounting regimes in cross-border transactions impose challenges not only for the government and tax authority, but also to the investors who want to start their business abroad. "*Different legal systems require that the investor consider a variety of new issues and develop strategies or dealing with each. Examples include: (i) higher levels of disclosure to regulatory authorities in the US than elsewhere; (ii) differing behavioral standards (...); (iii) minimum amounts of capital required to be invested by the foreign partner (eg 20 per cent of the initial joint venture capital in the Ukraine and 5 per cent in Indonesia); (iv) requirements of local purchase or manufacture, such as is the case in China; (v) restrictions on acquiring certain assets, such as land in Poland; (vi) the absence of any effective means of enforcement of legal rights, as in Russia and, (vii) different degrees of recognition afforded to intellectual property right, such as patent infringement and counterfeiting.*"[26]
In this regards, contracting parties in a tax treaty are expected to improve the communication between them to address the complexities in different legal system problems that will likely arise when cross-border transactions take place.

2.6 Double Tax Treaties and Domestic Law

"A double tax treaty is an agreement between states to coordinate the exercise of their taxing rights. Although it is between states, it has direct effect towards taxpayers. They can invoke treaty benefits and therefore request the application of treaty provisions."[27] Generally tax treaties are made based on the Model. The most common

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[25] Commission of The European Communities, *Communication From The Commission to The Council, The European Parliament and The European Economic and Social Committee regarding Co-ordination Member States' Direct Tax Systems in The Internal Market,* 25 October 2006.
[26] Arthur H Rosenbloom and Stephan H Haimo, *Cross Border Transactions: Look Before you Leap*, (1997) Business Law Review, p.257
[27] Chris Finnerty, Paulus Merks, Mario Petriccione, Raffaele Russo, *Fundamentals of International Tax Planning,* (2007), IBFD Publications BV, p. 11

used are OECD Model and the UN Models. Each Model have commentaries that functioned to give further explanation on how to implement the provisions, and are normally updated on periodical basis, considering the rapid changes in economy and developments. OECD Model designed for a negotiation between developed countries while UN Models is designed for negotiation between developed and developing countries, which it tends to facilitate broader taxing rights to the source state.[28]

Regarding the relation between double tax treaties and domestic law, there are two issues to be considered. The first one is how tax treaties do not generate the taxing rights. Double tax treaties create limitation on how each contracting state exercise their taxing rights once they are engaged in tax treaties. However, it is still domestic law, which constitutes taxing rights, and double tax treaty's role is to limit the taxing rights. The second consideration is that occasionally there will be difference found in definitions between double tax treaties and domestic law. For instance one particular type of income that is considered as royalty in domestic law does not automatically will also be considered as royalty in double tax treaty. Furthermore, the appropriate steps to be done when looking at the consequences of a cross-border transactions are too: "(i) determine the tax treatment on the basis of the applicable domestic legislation and (ii) verify whether and to what extent the relevant tax treaty has an impact on it."[29]

2.7 Tax Information Exchange Agreements (TIEAs)

(TIEAs) is a model agreement on exchange of information on tax matters, which is developed by the OECD Global Forum Working Group on Effective Exchange if Information, which purpose is to promote international co-operation in tax matters through exchange of information.[30] TIEAs came into force after the 1998 OECD Report "*Harmful Tax Competition: An Emerging Global Issue"* and that report identified "the lack of effective of exchange of information" as an issue in harmful tax competition.[31] This model agreement is not binding, however it contains two models for bilateral agreements, which are intended to establish criteria that determine effective exchange on formation. Each Article is accompanied with detailed commentary to interpret the provisions

2.8 The United Nations Model Convention and OECD Model Convention

United Nations (UN) Model Convention manifests the notion where a residence country should extend the measure to relief double taxation issue through foreign tax credit or an exemption, which is similar to OECD Model Convention. However, there are three considerations taken into account by United Nations Model Convention in balancing its approach to facilitate the negotiation, interpretation and practical application of bilateral tax treaties which are: "(a) taxation of income from foreign capital should take into account expenses allocable to the earnings of the income so that such income is taxed on a net basis, that (b) taxation should not be so high as to

[28] Chris Finnerty, Paulus Merks, Mario Petriccione, Raffaele Russo, *Fundamentals of International Tax Planning,* (2007), IBFD Publications BV, p. 11
[29] Chris Finnerty, Paulus Merks, Mario Petriccione, Raffaele Russo, *Fundamentals of International Tax Planning,* (2007), IBFD Publications BV, p. 13
[30] OECD Report on Agreement on Exchange of Information on Tax Matters, para (1) Preamble
[31] OECD Report on Agreement on Exchange of Information on Tax Matters, para (3) Preamble

discourage investment and that (c) it should take into account the appropriateness of the sharing of revenue with the country providing the capital".[32] United Nations Model Convention's consideration that lowering tax rate is an effective method to attract investment is not appropriate since lowering tax rate is not always coherent with attracting direct investment and without analyzing the condition of a country, and the implications of applicable provisions in the treaty could potentially harm national sovereignty.

[32] United National Model Double Taxation Convention between Developed and Developing Countries, (2011), p. ix

3. Developing Country's Issues in Cross-border transaction

3.1 Developing Country Handles Tax Collection in Cross-border Transaction

It is acknowledged that tax evasion and non-compliance behavior of Indonesian taxpayer is on the rise. The issue of high compliance cost because of the complexity of tax administration and uncertainty in the domestic tax law itself, corruption cases that involved tax authorities, less effective strategy in collecting tax by granting tax incentives to attract foreign direct investment and targeting income tax on individuals who have low income have affected taxpayers' compliance and behavior creating lack of respect toward tax law and tax authorities which in the long term decrease the effectiveness of tax collection. The objective of domestic tax law in Indonesia as well as the rest of the country in the world is to increase tax revenue.

The fact that Indonesia is a developing country, it depends on foreign investor to develop economic growth. Types of incentives given by the tax authorities to foreign investor come in the form of tax holidays, which gives exemption on certain activities, tax rate reduction, deductible expenses and tax credits. However, instead of strengthening tax administration and tax compliance behavior, double tax treaties to which Indonesia took part resulting in inefficient tax collection. OECD Report on Corporate Tax Incentives for Foreign Direct Investment in Developing Countries mentioned that there have been several empirical studies to review the significance of tax incentives in attracting Foreign Direct Investment (FDI). The Report showed that it is indeed that tax incentives influence FDI, nevertheless, not all tax incentives will actually influence the FDI, there were tax incentives that even disadvantageous.

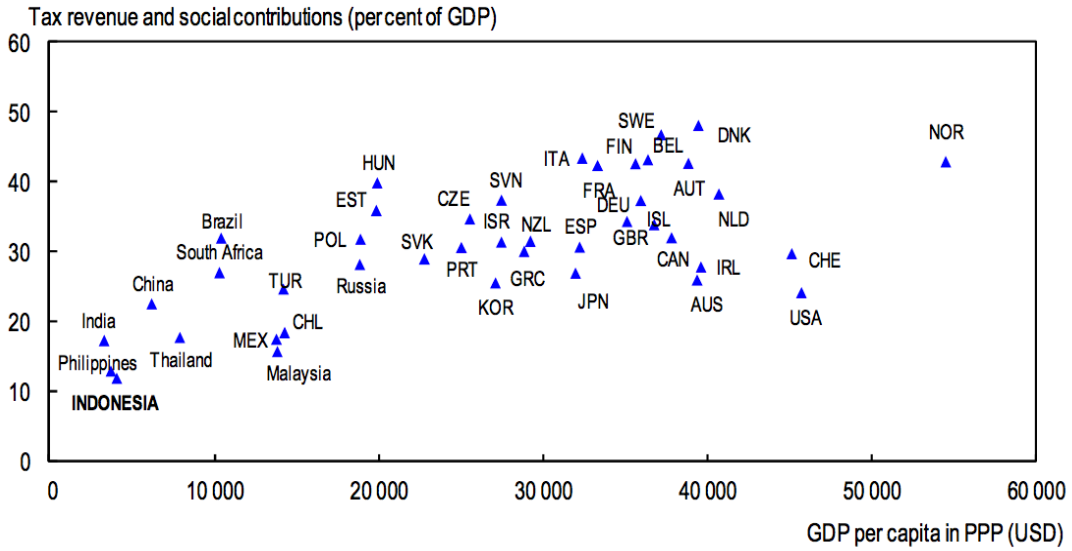
3.2 Challenges in Indonesia's Tax System

Indonesian authorities have set up ambitious development targets as well as tax target as the financial support for the development, especially in order to enhance the infrastructure and to expand social safety net, which need conspicuous amount of financial support. Simultaneously, there will be political demand for improvements in public goods provided by the government as well as social security programs. Not to miss the need of a change toward a greener economy will be an additional expenditure needs. The variety of these objectives requires more public revenues and this is the principal challenges for Indonesian tax system in the future.[33]

[33] Jens Arnold, *Improving the Tax System in Indonesia,* OECD Economics Department Working Papers No. 998, (2012) p. 5

Figure 1. **Indonesia's tax revenues and GDP per capita**

2009



Source : OECD Revenue Statistics, International Monetary Fund (IMF) Government Finance Statistics, Indonesia Ministry of Finance, Philippines Department of Finance

Indonesia has the lowest ratio of general government tax revenues to Gross Domestic Product (GDP) in The Group of Twenty (G20) countries[34] which are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union. As a comparison, other Association of Southeast Asian Nations (ASEAN) countries could collect more than 15% of GDP in tax revenues in 2009, while the average OECD countries were at 33,8% GDP excluding non-tax revenues.[35]

Even though Indonesia has revised the tax revenue target by lowering from IDR 1.280, 38 trillion (EUR 90 Million) to IDR 1.246,1 trillion (EUR 85 Million), however, until the end of 2014, the realization of tax revenue was not able to fulfill the target.

3.3 Tax Incentive as a Tool to Attract Foreign Investment

The development that is performed by a State requires high cost. Apart from within the country, another source of funding can be obtained from foreign country, which comes in the form of foreign investment. There are several tools that can be use to attract foreign investment. Gergely mentioned that there are several types of incentives that are rendered to attract investment, such as fiscal incentive (tax

[34] Jens Arnold, *Improving the Tax System in Indonesia,* OECD Economics Department Working Papers No. 998, (2012) p. 5
[35] Jens Arnold, *Improving the Tax System in Indonesia,* OECD Economics Department Working Papers No. 998, (2012) p. 5

incentive), financial incentive (subsidies), and other type of incentives (such as market protection).[36]

However there are few differences between the incentives given by the developing countries and by the developed countries. Developed countries opt to use financial incentives in the form of subsidies while developing countries prefer to give tax incentive.[37] The differences arise because most of the developing countries do not have sufficient funding that can be allocated for giving subsidies.[38] Goodspeed indicates that more than half of 71 developing countries prefer to use tax incentive, and the remaining 20% of the developing countries opt to give subsidies. In comparison, from 20 OECD Member States, there is 45% who prefer to give subsidies and 20% opts to offer tax incentive in order to attract foreign investment.[39]

There are considerable reason that lead to above differences, which are[40]: firstly, it is easer to give tax incentives, compared to overcoming the deficiency of economic fundamentals such as infrastructure and labor issues. Secondly, tax incentives do not require funds directly as granting a subsidy. Lastly, the existence of competition with other countries in order to attract foreign investment.

The author will primarily describe theoretical study over tax incentives which is then followed by the historical studies on tax incentives that have already been applied in Indonesia. In comparison, there will be an explanation on similar program carried out in Singapore and Hong Kong.

3.4 What is Tax Incentive?

United Nations Conference on Trade and Development (UNCTAD) defines tax incentives as "*...any incentives that reduce the tax burden of enterprises in order to induce them to invest in particular projects or sectors.*"[41] Easson gives another definition stating that essentially, tax incentive is "*...a special tax provisions granted to qualified investment projects ... that represents a statutorily favorable deviation from a corresponding provision applicable in investment projects in general.*"[42] Based on the definition above, it can be concluded that tax incentive is basically the deviation of tax provisions which are generally applicable. Tax incentive is usually given accompanied by certain requirements, such as a company must establish its business in particular location, limitation on business turnover, and requirement for the company to create technology transfer. The requirement might also come in the

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[36] Judith Gergely, *Trends in Foreign Direct Investment Incentives,* European Communities Studies Association Working Paper, (2003)

[37] United Nations Conference on Trade and Development (UNCTAD), *Tax Incentives and Foreign Direct Investment: A Global Survey,* ASIT Advisory Studies No. 16 (2000)

[38] Timothy Goodspeed, *Taxation and FDI in Developed and Developing Countries,* in James Alm, Jorge Martines-Vazques and Mak Rider (eds), *The Challenges of Tax Reform in a Global Economy (Springer, 2006),* 137

[39] Timothy Goodspeed, *Taxation and FDI in Developed and Developing Countries,* in James Alm, Jorge Martines-Vazques and Mak Rider (eds), *The Challenges of Tax Reform in a Global Economy (Springer, 2006),* 137

[40] Nargiza Yakubova, *Policy Matters: Tax Incentives for Business Investment,* European Journal of Business and Economics, (2013)

[41] United Nations Conference on Trade and Development (UNCTAD), *Tax Incentives and Foreign Direct Investment: A Global Survey,* ASIT Advisory Studies No. 16 (2000)

[42] A. J. Easson, *Tax Incentives for Foreign Direct Investment,* Kluwer Law International, (2004)

form of demand that the profit of company is not distributed in the form of shares, instead, it should be re-invested in particular project or period.

UNCTAD also stated that there several goals to be achieved in granting tax incentives, namely:[43]

1. To increase investment in certain areas
2. To increase investment in certain business sectors
3. To increase the performance
4. Technology transfer

To achieve the above purposes, there are several types of tax incentives that normally used. For example, in the context of achieving technology transfer, tax incentive that is given is in the form of accelerated depreciation, reduction of withholding tax on dividends or royalties, or in the form of tax holiday.[44]

Tax holiday is considered as "the most convenient" of all alternatives since taxpayers are not required to calculate the amount of tax payable during the period of tax holiday. Nevertheless, developing countries prefer to reduce the income tax rates followed by tax holiday and developed countries opt to use accelerated depreciation.[45] Most of these incentives are given to certain sectors (e.g. manufacturing, infrastructure), certain areas (the areas that are considered to be less developed), or to export-oriented industries (mainly used in the developing countries).[46]

Notwithstanding many countries provide tax incentives, in fact it is still remains a contention whether tax incentives have had a significant influence to increase investment. One might state that there is possibility that the granting of tax incentives can attract foreign investment in certain conditions. However, on the other hand, even without such incentives, investment will still occur, and what happens is a state loosing the tax revenue without obtaining benefit of any kind. It also important to consider that tax incentive could lead to tax avoidance[47] by *round tripping, double dipping, and transfer pricing.*[48] Especially, developing countries have the issue in which the ability of tax authorities to conduct supervision is relatively limited.[49] As a consequence, there are debates stating that tax incentive would only erode tax bases and not necessarily attracts investment significantly.[50] This is supported by a research conducted by Stefan Parys and Sebastian James in Africa, which shows that there is no positive correlation between the granting of tax holiday and investment.[51]

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[43] United Nations Conference on Trade and Development (UNCTAD), *Tax Incentives and Foreign Direct Investment: A Global Survey,* ASIT Advisory Studies No. 16 (2000)
[44] United Nations Conference on Trade and Development (UNCTAD), *Tax Incentives and Foreign Direct Investment: A Global Survey,* ASIT Advisory Studies No. 16 (2000)
[45] Nargiza Yakubova, *Policy Matters: Tax Incentives for Business Investment,* European Journal of Business and Economics, (2013)
[46] Nargiza Yakubova, *Policy Matters: Tax Incentives for Business Investment,* European Journal of Business and Economics, (2013)
[47] Nargiza Yakubova, *Policy Matters: Tax Incentives for Business Investment,* European Journal of Business and Economics, (2013)
[48] Alex Easson and Eric M. Zolt, *Tax Incentives,* World Bank Institute (2003), p. 16
[49] Nargiza Yakubova, *Policy Matters: Tax Incentives for Business Investment,* European Journal of Business and Economics, (2013)
[50] Alex Easson and Eric M. Zolt, *Tax Incentives,* World Bank Institute (2003), p. 16
[51] Stefan Parys and Sebastian James, *The Effectiveness of Tax Incentives in Attracting Investment: Panel Data Evidence from the CFA Franc Zone,* International Tax and Public Finance, (2010), p. 400

Most investors are inclined to think that an overall tax system in a country is often more important than tax incentives offered.[52] What is considered as an important factors are legal certainty, simplicity of tax system and transparency. In this case, tax incentive is only treated as an additional bonus. Therefore, Yakubova suggested that simplifying the tax system is what is needed to be done, reduce the distortion caused by taxes, eliminating unnecessary cost of administration and cost of compliance, increase the transparency, and improve the ability of government in collecting the revenue.[53] This is what has been done in Indonesia while conducting the tax reform in the 1980s.

In the research, Klemm and Van Parys found that tax incentive has no correlation to foreign investment in Africa, however, in America and Caribia, reduced tax rate and tax holiday had given significant influence on increased foreign investment.[54] This indicates that tax incentives is beneficial in certain condition and the policy makers need to pay attention on designing the tax incentive.[55] Starting from the selection of the business sector in which the tax incentive will be given, that sector should have sensitive nature, for example to the services sector and retail.[56]
The incentives could also be designed for the research and development. However, it should be noted that tax incentive will not be able to significantly boost the research and development in a company that had never perform such activities.[57] For this type of company, it will be more effective if the incentive is given in the form of financial incentive.[58]

The importance of designing tax incentive can be seen in Hong Kong and Singapore which relatively prosperous by relying on tax (even though there are fundamental difference between these two countries).[59] In this context, Hong Kong choose to not give tax incentive and it prefers to design its tax system with low tax rates for all taxpayers. This condition support the realization of relatively simple tax system.[60] As a result, there is no significant difference between the foreign investment that goes to Hong Kong and foreign investment that goes to Thailand which has more liberal tax incentive policy.

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[52] Nargiza Yakubova, *Policy Matters: Tax Incentives for Business Investment,* European Journal of Business and Economics, (2013)
[53] Nargiza Yakubova, *Policy Matters: Tax Incentives for Business Investment,* European Journal of Business and Economics, (2013)
[54] Alexander Klemm and S. Van Parys, *Empirical Evidence on The Effects of Tax Incentives,* International Tax and Public Finance, (2012), p. 393
[55] Alex Easson and Eric M. Zolt, *Tax Incentives,* World Bank Institute (2003), p. 16
[56] Andrew Hanson and Shawn Rohlin, *Do Location-based Tax Incentives Attract New Business Establishment?,* Journal of Public Economics, (2002), p. 1
[57] Nick Bloom, Rachel Griffith and John Van Reenen, *Do R&D Tax Credits Work? Evidence from a Panel of Countries 1979-1997,* Journal of Public Economics, (2002), p. 1
[58] Isabel Busom, Beatriz Corchuelo and Ester Martínez Ros, *Tax Incentive … or Subsidies for Business R&D?,* Small Business Economics, (2014)
[59] Stephen Pua Lye Huat and Andrew Halkyard, *The Impact of Tax Incentives on Economic Development in Singapore and Hongkong,* in Nolan Cormac Sharkey (ed), *Taxation in ASEAN and China: Local Institutions, regionalism, Global Systems and Economic Development,* Routledge, (2012), p. 191
[60] M. Littlewood, *Taxation without Representation: The History of Hongkong's Troublingly Successful Tax System,* Hongjong University Press, (2010)

On the contrary, Singapore in its initial two decades after gaining the independence, tend to be easier in giving incentives. Nevertheless, the granting of incentives in Singapore began to prove less effective. Currently, Singapore is in the transformation towards *knowledge-based economy* so that the incentives now are more aligned to support the transformation. Hence, it can be seen that the granting of tax incentives have been designed according to the long-term goal in which every states wish to achieve.

3.5 Tax Incentive in Indonesia

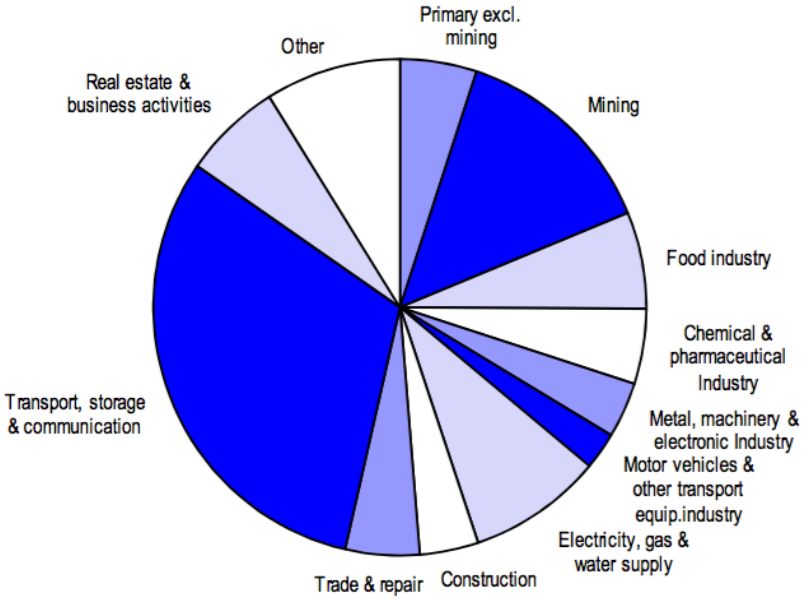
Tax Incentive is not a new issue in Indonesia. In 1967, Indonesia started to give tax holiday to attract foreign investment. Tax holiday is considered to be potential tool to attract foreign investment, especially in 1967 when the applicable income tax rate was relatively high, which reaches 60%. A year later, the facility that previously only applicable for foreign investor turned out to be extended to domestic investor for justice reason. In general, a company could enjoy tax-free facilities for six years.

The provision of this tax incentive causing a complicated tax system in Indonesia. As a result, tax compliance rate is relatively low and the community is reluctant to know about the rules of taxation. Therefore, in order to produce a simpler system, tax authorities tried to do the reformation by abolishing various tax incentives. The elimination of the tax incentive was not easy. There were debates between parties who did not support the elimination of tax incentives and tax authority, who supported the elimination of the tax incentives.[61] Furthermore, even after the tax incentives are removed, the number of foreign investment that came to Indonesia at that time continued to grow despite many countries still provide tax incentives.[62] It is similar to what happened in Hong Kong, which indicates that investment will still enter a country as long as there is safe environment and interesting climate for business and market.

[61] Malcolm Gillis, *Comprehensive Tax Reform: The Indonesian Experience 1981-1988,* in Malcolm Gillis (ed), *Tax Reform in Developing Countries,* Duke University Press, 1989, p. 79
[62] Louis T. Wells et al, *Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Costs?,* Washington DC: World Bank and The International Finance Corporation, (2001), p. 15

Figure 2. **FDI net inflows by sector**

2010



Source : Bank Indonesia

There are several principal impediments to FDI inflows to Indonesia such as difficulties in the business environment, the complexity in Government institutions' bureaucracy, skills and infrastructure. And tax rate is only a small fraction of elements affecting investors' decision in choosing location to start businesses.[63]

Based on the figure above, the Indonesian government approved several numbers of corporate tax incentives that have the objective to support "cluster" industries, which are considered as having essential role to expand regional development and to foster national economy. The tax incentives are available for 16 sectors, and for individual project it becomes accessible once the chairman of the Investment Coordinating Board (BKPM) has given the approval.[64] Furthermore, the government has also declared a temporary corporate income tax holidays for three years for new corporate taxpayers who invest at least IDR 1 trillion (EUR 70 million) in so-called '*pioneer industries*', that includes "base metals, oil refining, textile machinery, alternative energy and telecommunications equipment."[65] The actions of providing tax incentives might potentially erode the revenue from corporate tax, distort the corporate tax, and create the opportunities to policy capture. Outright tax holidays are generally regarded as the most unfavorable form of tax incentives, considering the risk of generating

[63] Jens Arnold, *Improving the Tax System in Indonesia,* OECD Economics Department Working Papers No. 998, (2012) p. 14
[64] Jens Arnold, *Improving the Tax System in Indonesia,* OECD Economics Department Working Papers No. 998, (2012) p. 14
[65] Jens Arnold, *Improving the Tax System in Indonesia,* OECD Economics Department Working Papers No. 998, (2012) p. 14

corruption in the tax system and might complicate tax authorities in evaluating the foregone revenues.[66]

[66] Jens Arnold, *Improving the Tax System in Indonesia,* OECD Economics Department Working Papers No. 998, (2012) p. 14

4. Methods to Eliminate Double Taxation[67]

There are three methods used to eliminate double taxation such as: Firstly, the exemption method which is in line with Capital Import Neutrality (CIN). CIN ensures a country to impose the same amount of tax on the income of foreign investors and local investors from equal investments made in the country. Capital Import Neutrality comes when the country applies the tax exemption method as its policy, hence, the exemption method is in line with CIN.
The exemption method consists of two type of exemptions which are full exemption, which excludes foreign source income and the resident's tax rate simply applies to taxpayer's domestic source income in resident country only, and exemption with progression allows resident country to take the amount of exempted income into account when determining the tax to be imposed on the non-exempt income.

The second method that can be used to eliminate double taxation is the foreign tax credit method that consists of full credit method and ordinary credit. In the full credit method, the resident country allows its resident to claim full credit for the whole amount of taxes paid to source country on the resident's foreign source income. Ordinary credit method will calculate the way of allocating proportionate share of the taxpayer's total income tax liability in resident country on its worldwide income to its foreign source income.
Capital Export Neutrality (CEN) is the condition when the investors face the same effective domestic tax rate whether they invest at home or abroad. By doing this, the tax system is neutral between investors of a country investing at home or abroad because they are treated at home country the same way. In other words, CEN is in line with the tax credit method.

The last method to eliminate double taxation is deduction method, which allows resident country to tax foreign source income and grants the taxpayers a deduction from their assessable income in calculating their tax liability in resident country, for foreign taxes paid on the foreign income. This method fails in giving full relief from double taxation. Furthermore, deduction method is not in line with neither CIN nor CEN.

4.1 Matching Credit

When a DTC is concluded with developing countries, matching credit is sometimes granted. In Matching Credit, "a notional amount of foreign taxes established in the relevant allocation rule or in the method article is deemed to be levied at source and is credited by the residence state even if the tax is not actually levied in the source state or a lower amount of tax is levied".[68] This matching credit is aimed to accelerate capital investments in the developing countries. This method also disables the residence state to benefit, where the investor is located, from non-taxation or reduced tax from the source state. In the situation where there is no matching credit mechanism, the residence state would directly credit less foreign tax and "would

[67] Kelvin Holmes, *International Tax Policy and Double Tax Treaties,* IBFD, (2014), p. 23
[68] Michael Lang, *Introduction to the Law of Double Taxation Conventions (Second Revised Edition),* IBFD, (2015), 451

therefore frustrate the non-taxation or reduced taxation by the source state".[69] All the benefit that comes out from this method will go to the investor, because the residence state will provide a credit on a notional basis irrespective of the amount that has been paid in the source state, which in other words means the investor will obtain the advantage.[70]

The example of Matching Credit: "*A French company derives interest arising in Brazil. Under the Brazil-France DTC, this interest may be taxed in Brazil. According to Art. XXII(2)(c) of the Brazil-France DTC, with regard to interest which has borne Brazilian tax in accordance with the provisions of the DTC, France shall allow its residents receiving such income a tax credit corresponding to the amount of Brazilian tax that has been paid, within the limits which the French tax establishes in such income. Under Art. XXII(2)(d) of the Brazil-France DTC, with regard to interest, the Brazilian tax shall be considered to have been levied at a minimum rate of 20%. The French company deriving interest arising in Brazil is thus entitled to a tax credit corresponding to at least 20% of the interest, irrespective of whether lower tax is actually levied in Brazil."*[71]

4.2 Sparing Credit

Sparing Credit method is a credit method, which based on notional amount. Under this method, when source state is granting an exemption or reduction, the residence state will grant a credit in the basis of fictitious amount of foreign taxes, which the source state would levy if there is no reduction or exemption were granted.[72]

The Example of Sparing Credit: "*A Belgian company derives interest arising in India. This interest may be taxed in India under the Belgium-India DTC. According to Art. 23(3)(b)(i) of the Belgium-India DTC, when a resident of Belgium derives interest taxable in India in Accordance with Art.11(2) or (6), the Indian tax levied on that income shall be allowed as a credit against Belgian tax related to such income. Art.23(3)(e) of the Belgium-India DTC also provides that: "For the purposes of sub-paragraph (b)(i) the term 'Indian tax levied' shall be deemed to include any amount which would have been payable as Indian tax under the laws of India and in accordance with the provisions of the Agreement for any year…", except for some exemptions or reductions listed in that provisions of the DTC. Based on the above, the Belgian company deriving interest from India is entitled to a tax credit for the amount of taxes that would have been payable as Indian tax, even if no taxes are actually levied in India (unless the non-taxation in India is grounded on those exemptions or reductions that are listed in the Belgium-India DTC)."*[73]

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[69] Michael Lang, *Introduction to the Law of Double Taxation Conventions (Second Revised Edition),* IBFD, (2015), 451

[70] Michael Lang, *Introduction to the Law of Double Taxation Conventions (Second Revised Edition),* IBFD, (2015), 451

[71] Michael Lang, *Introduction to the Law of Double Taxation Conventions (Second Revised Edition),* IBFD, (2015), 452

[72] Michael Lang, *Introduction to the Law of Double Taxation Conventions (Second Revised Edition),* IBFD, (2015), 453

[73] Michael Lang, *Introduction to the Law of Double Taxation Conventions (Second Revised Edition),* IBFD, (2015), 454

Reflecting on the "ability to pay" doctrine by Adam Smith which tax should be impose "in proportion to their respective abilities"[74] seemed contradictive with the situation in Indonesia where the tax authorities are targeting individual income tax on low-income taxpayer while there is potentially effective source of tax which is cross-border transactions.

There are several deficiencies in the structure of tax administration in most of developing countries that potentially detrimental to a country's objective of collecting tax when they participate in double tax treaty. Such as: "lack of computerization, weak external control over tax officials by the legislature, complexity and uncertainty in tax legislation and so forth that render tax controls less operative."[75] However, Indonesia has attempted to address such deficiency in tax administration when dealing with cross-border transactions by adopting Indonesian Mutual Agreement Procedure.

4.3 Indonesian' Mutual Agreement Procedure

Indonesia has Advance Pricing Agreement as a solution to solve tax dispute unilaterally. Furthermore, in 2010, Indonesian Directorate General of Taxation (DGT) issued Minister of Finance Decree number 48/PJ./2010 which been updated with Minister of Finance Decree number 240/PMK.03/2014 regarding Mutual Agreement Procedure (MAP). MAP in Indonesia is an administrative procedure done by Indonesian DGT and Tax Authority from contracting party that deals with problems arising from Double Tax Treaty. Firstly, this procedure deals with transfer pricing issue, and corresponding adjustment as the result of transfer pricing correction done by primary adjustment produced by tax authorities in other contracting party to meet consistency in allocating income to prevent double taxation. Secondly, this procedure deals with dual residence issue where one person is considered as taxpayer in both jurisdictions. Thirdly, this procedure deals with Advance Pricing Agreement (APA), which is an agreement between Directorate General of Taxation and Taxpayers, or Directorate General of Taxation with tax authority from other contracting state that involves taxpayer.

Parties that are able to request the MAP are stated in Article 3 in Indonesian MAP, which are: taxpayer through Directorate General of Taxation; Directorate General of Taxation; and tax authorities in other contracting party. MAP run by Directorate General of Taxation shall be conducted by the Director of Tax Regulation II who acts as competent authority in Indonesia. After MAP is requested, Director of Tax Regulation II will start the process by performing several stages starting from requesting supporting documents, further explanation and additional information from taxpayers. Based on the investigation, the Director of Tax Regulation II will decide whether the request of MAP can be granted or not. The shortcomings in Indonesian MAP can be examined from the ambiguity in Article 4 in Indonesian MAP regarding the time limit of MAP request, which can not be found either in Double Tax Treaty and domestic law and may create unlimited duration of MAP.

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[74] Adam Smith, *An Inquiry into the Nature and Causes of The Wealth of Nations,* (2009), Project Gutenberg Ebook

[75] Phyllis Lai Lan Mo, *Tax Avoidance and Anti-Avoidance Measures in major Developing Economies,* (2003), Greenwood Publishing Group, p. 80

Indonesian MAP also does not enforce obligation for the competent authority to give decision on the outcome of the dispute. Particularly, Article 18 paragraph 3 stated that related to MAP request regarding transfer pricing transaction, Director Tax Regulation II will investigate on the existence of specific provision regarding 'Corresponding Adjustment' as additional consideration to decide whether or not the request of MAP should be granted. Whereas, not all double tax treaty made by Indonesia regulate the provision of 'Corresponding Adjustment'.[76] Article 9 (3) of the United Nation Model Convention also stated that 'Corresponding Adjustment' shall not apply if one of the contracting parties in the primary adjustment is liable to penalty with respect to fraud, gross negligence or willful default. Although Indonesia has several challenges in conducting effective tax collecting regarding cross-border transactions, there is positively room for improvement.

4.4 Difference in Legal System Requires Communication Tool

There has been action made by several countries in the world to strengthen the power of tax administration in obtaining taxpayer's information regarding their assets, which takes place outside the country. Bilateral agreements between countries have called for tax information exchange. Countries with high-tax had a goal to create the same level of compliance between foreign accounts and domestic accounts, however, in order to achieve that goal, they need automatic information exchange since information exchange on request was limited because it demanded for a common knowledge that a certain person was not reporting their tax properly, and without proper form of tax cooperation between tax authorities, tax collection would utterly depend on the report by the taxpayers who might have a tendency to under-report their tax.[77] United States (US) finally created FATCA (Foreign Accounts Tax Compliance Act) provision unilaterally which is a form of automatic information exchange system and is enacted on 18 March 2010, this provision requires individuals and foreign financial institutions in United States to report their financial accounts held outside the country to Internal Revenue Service (IRS).[78]

FATCA is not an agreement between two contracting states. It is a "*measure created by one state that put legal mandates on corporate citizens of other states*."[79] This forms a further question on whether US law contains an infringement of other states' sovereignty. US indeed has a legal control over its residents and its financial institutions as well as US subsidiaries and branches of foreign institutions. However, it will be inappropriate to justify US jurisdiction on foreign company based on that the foreign company has a subsidiary and branch in US.[80] Professor J. Richard Harvey in his opinion on FATCA stated that US has the right to protect its tax base. His statement provoked debates on how it is well acquainted that every country has the right to protect its tax base, however, the exercise of protecting tax base in every

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[76] From 64 Double Tax Treaty to which Indonesia is involved, there are 42 double tax treaty which contains 'Corresponding Adjustment'

[77] Robert F. van Brederode, *A Normative Evaluation of Tax Law Enforcement: Legislative and Political Responses to Tax Avoidance and Evasion,* 2014, Intertax Volume 42, p. 773

[78] Foreign Account Tax Compliance Act (FATCA), The FATCA is part of the 2010 Hiring Incentives to Restore Employment (HIRE) Act, enacted by the 111th United States Congress on March 18, 2010.

[79] Robert F. van Brederode, *A Normative Evaluation of Tax Law Enforcement: Legislative and Political Responses to Tax Avoidance and Evasion,* 2014, Intertax Volume 42, p. 774

[80] Robert F. van Brederode, *A Normative Evaluation of Tax Law Enforcement: Legislative and Political Responses to Tax Avoidance and Evasion,* 2014, Intertax Volume 42, p. 774

country should not harm or violate other country's sovereignty.[81]

To address the issue of infringing the sovereignty of other countries, US enters Intergovernmental Agreements (IGA) with other countries which essentially trough these bilateral agreements, FATCA are introduced to the national law of each foreign country who enters IGA with US and they shall enact the domestic legislation and require Foreign Financial Institutions (FFI) to collect information on US accounts to be reported to the local tax authorities. IGA finally addressed the issue of violation of sovereignty in the sense of the other countries voluntarily enter the negotiation with US.[82]

4.5 EU Solution in fighting Tax Evasion and Tax Avoidance

European Union has also been aware of this problem and has already introduced variety of actions to address the cooperation between Member States' tax administrations. There are three Directives currently active in European Union: the Savings Directive, the Recovery of Collection Directive, and the Automatic Exchange Directive.

4.5.1 The Savings Directive

The Council Directive 2014/48/EU, of 24 March 2014 is amending Directive 2003/48/EC on taxation of savings income in the form of interest payments.[83] This Directive obliges Member States to do the automatic exchange of information by requiring the paying agents[84] to apply a 'look-through approach' to payments made to certain entities or legal arrangements established or having their place of effective management in certain countries or territories where Directive 2003/48/EC did not apply.[85]

The Objective of Savings Directive
The Directive has the objective to "enable savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident in another Member State to be made subject to effective taxation in accordance with the laws of the latter Member State" since before, there was no coordination of national tax systems for taxation of savings income and residents of Member States were considered able to avoid any form of taxation in their Member State of residence on interest they receive in another Member State.[86]

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[81] Robert F. van Brederode, *A Normative Evaluation of Tax Law Enforcement: Legislative and Political Responses to Tax Avoidance and Evasion,* 2014, Intertax Volume 42, p. 774
[82] Robert F. van Brederode, *A Normative Evaluation of Tax Law Enforcement: Legislative and Political Responses to Tax Avoidance and Evasion,* 2014, Intertax Volume 42, p. 774-775
[83] Council Directives 2014/48/EU on taxation concerning savings income in the form of interest payments (Savings Directive)
[84] Savings Directive, art. 4 'Paying Agents': An economic operator established in a Member State who makes an interest payment to, or secures such a payment for, the immediate benefit of the beneficial owner shall be considered to be a paying agent for the purposes of this Directive
[85] Savings Directive, para. 1.
[86] Council Directive 2003/48/EC on taxation of savings income in the form of interest payments

4.5.1.1 Procedure

This Directive constitutes all Member States to force people who make interest payments and also other financial instruments such as interest-bearing securities and other indirect means of holding interest-bearing securities to provide information to the tax authorities, to be exchanged automatically with tax authorities from other Contracting State.[87] Beside defining "beneficial owner: and "paying agent". These Directives also provides other definitions of certain terms such as: "economic operator", "place of effective management", "subject to effective taxation", "beneficial owner", and "interest payment".

4.5.1.2 Beneficial Owner

"Beneficial Owner means any individual who receives an interest payment or any individual for whom an interest payment is secured, unless he provides evidence that it was not received or secured for his own benefit".[88]
Regarding the beneficial owner, this Directive requires the paying agent to establish the identity of the beneficial owner. For contractual relations before 1 January 2004, the identity should include name and address of the beneficial owner, however, for the contractual relations after 1 January 2004, the information regarding the identity should provide name, address, date and place of birth, and also tax identification number or equivalent. Information about date and place of birth are required if the tax identification number is not available.[89]

Not only providing tax identification numbers or equivalent, the Member States are also required to inform the Commission about the structure and format of the Tax Identification numbers, as well as other official documentation containing information. Member States also need to inform if any changes occur. Additionally, the Commission will publish the 'Official Journal of The European Union' as the guidance of the information provided.[90]

4.5.1.3 Paying Agent

This Directive requires 'paying agent': "The paying agent is the economic operator who pays interest to or secures the payment of interest for the immediate benefit of the beneficial owner"[91] to make sure the information available to tax authorities of Member States where the business is established who will supply the information for the tax authorities in state of resident of the interest recipients.[92]

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[87] Ben. J.M Terra and Peter J. Watel, *European Tax Law – Abdridge Student Edition,* (2012) Wolters Kluwer p. 404 *see also* Council Directives 2014/48/EU on taxation concerning savings income in the form of interest payments (Savings Directive) Para (1) Preamble
[88] Savings Directive, art. 2
[89] Savings Directive, Art. 3
[90] Savings Directive, Art. 3
[91] Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, Para. (11) Preamble
[92] Maarjana Helminen, *EU Tax Law Direct Taxation,* (2013) IBFD

4.5.1.4 Competent Authority

In this Directive, 'competent authority' means (a) "for Member States, any of the authorities notified by the Member States to the Commission, (b) for third countries, the competent authority for the purposes of bilateral or multilateral tax conventions or, failing that, such other authority as is competent to issue certificates of residence for tax purposes."[93]

4.5.1.5 Interest Payments

Article 6 of Savings Directive covers broad and numerous components, which would not be listed as interest under domestic law.[94] In this Directive, 'interest payment' means interest paid or credited to an account, relating to debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and, in particular, income from government securities and income from bonds or debentures, includes premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payments shall not be regarded as interest payment;[95]
This Directive's 'interest payments' also covers any income relating to securities of any kind, they could be paid or realized, or credited to an account; accrued or capitalized interest at the sale, and refund or redemption of the debt claims.[96]

4.5.1.6 Intermediate Remarks

From the explanation provided above, it can be acknowledged that EU has attempted to expand the coverage of form of taxation which is interest payments in Savings Directive. In order to do that, Member States are required to do the automatic exchange of information. It could be argued that this Directive is going to be able to create a effective taxation since the definition 'beneficial owner' in this Directive is specified as "individual". One could easily escape this Directive by changing the form of investment into shares or transferring the funds into a trust or foundation.

However, in this context, the idea of broadening the scope of taxation by enabling savings income in the form of interest payments could potentially help Indonesia in optimizing the tax collection, considering Indonesia does not have automatic exchange of information rule in its tax system and 'a look-through approach' which the author strongly believes that the broader the scope of taxation, the narrower the chance of taxpayers to avoid the tax.

4.5.2 The Recovery of Collection Directive

The Council Directive 2010/24/EU, of 16 March 2010 is a Directive concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures.[97] This Directive is the extension of the Mutual Assistance Directive in the

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[93] Savings Directive, Art. 5
[94] Savings Directive, Art. 6; *see also* Maarjana Helminen, *EU Tax Law Direct Taxation,* (2013) IBFD
[95] Savings Directive, Art. 6 (1)(a)
[96] Savings Directive, Art. 6 (1)(b,c)
[97] Council Directive 2010/24/EU concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures (Recovery of Collection Directive)

recovery of tax claims.[98] The arrangements for mutual assistance in European Union had been started since it was first set out in Council Directive 76/308/EEC of 15 March 1976 for the European Agricultural Guidance and Guarantee Fund and agricultural levies and customs duties, and it was amended by the Council Directive 2008/55/EC of 26 May 2008 on mutual assistance for the recovery of claims relating to certain levies, duties, and taxes and other measures, however this amendment have proved insufficient to meet the requirement of internal market, whereby a modification was needed, and the latter should be repealed by new instrument providing a clearer and precise rules.

The Objective of Recovery Directive
Given the increasing mobility in internal market, the Directive has the objective to ensure the fiscal neutrality when it allows Member States to remove discriminatory protective measures in responding the assistance requests in cross-border transactions designed to prevent fraud and budgetary loss in internal market or in other word, to better safeguard the financial interests of the Member States by providing more effective and efficient assistance in order to provide better result.[99]

4.5.2.1 Procedure

This Directive is expected to cover all forms of claims of the public authorities relating to taxes, duties, levies, refunds and intervention including all pecuniary claims and also to make sure that disparities in national laws and lack of coordination between contracting states will not jeopardize the operation of this Directive.[100]
"The requested authority may supply the applicant authority with the information which the latter needs in order to recover claims arising in the applicant Member State and notify to the debtor all documents relating to such claims emanating from the applicant Member State. The requested authority may also recover, at the request of the applicant authority, the claims arising in the applicant Member State, or take precautionary measures to guarantee the recovery of these claims."[101]

This Directive requires the communication to be made in digital form to make the procedure easier and faster.[102] In order to achieve the efficiency while handling the request of assistance from applicant authority, the requested authority can apply its power under its own national laws concerning the similar or the same taxes. However, if there are no similar or same taxes, it is then permissible to use the power provided under the requested authority's national law on personal income.[103]

In giving assistance for the applicant authority, the requested authority shall notify the addressee regarding all documents related to the claim in Article 2 (Scope of Recovery Directive) and to its recovery.[104] Regarding the request of the information,

[98] Recovery of Collection Directive
[99] Recovery of Collection Directive
[100] Council Directive 2010/24/EU concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures (Recovery of Collection Directive).Para (5-6) Preamble
[101] Recovery of Collection Directive, Para (7) Preamble
[102] Recovery of Collection Directive, Para (11) Preamble
[103] Recovery of Collection Directive, Para (14) Preamble
[104] Recovery of Collection Directive, Art. 8

there are several 'limitation' where the requested authority is not obliged to provide information to the applicant authority if:

a. The information will not be able to obtain
b. The information will disclose commercial, industrial and professional secrets;
c. The information will detriment security or contrary to public policy of the requested Member State.[105]

Article 18 also covers the limitation of the requested authority's obligations that includes the economic and social situation of its own national, time limit of the request, and threshold of the claims.
However, the requested authority will not be able to decline the request of the applicant authority on the base of the information is held by bank or financial institutions or related to ownerships interest in a person.[106]

In the execution of the request, Article 13 of the Directive stated that:
"For the purpose of the recovery in the requested Member State, any claim in respect of which a request for recovery has been made shall be treated as if it was a claim of the requested Member State, except where otherwise provided for in this Directive. The requested authority shall make use of the powers and procedures provided under the laws, regulations or administrative provisions of the requested Member State applying to claims concerning the same or, in the absence of the same, a similar tax or duty, (...)"[107]

The requested authority shall take precautionary measures in handling the request of the applicant authority as long as it is in accordance with its own national law.

4.5.2.2 The Cost

The requested authority shall seek to recover from the person concerned and retain the costs linked to the recovery that it incurred, in accordance with the laws and regulations of the requested Member State.[108] Member States also required to renounce all claims on each other for the reimbursement of costs arising from any mutual assistance they grant each other pursuant to this Directive. However, when a specific problem arises, the applicant and requested authorities may agree on reimbursement arrangements.[109]

4.5.2.3 Language Requirements

Request for assistance, standard forms for notification, and uniform instruments permitting enforcement shall be accompanied by translation into the official language, or one of the official languages of the requested Member State. The differences in language shall not affect the validity.[110]

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[105] Recovery of Collection Directive, Art. 5
[106] Recovery of Collection Directive, Art. 5
[107] Recovery of Collection Directive, Art. 13
[108] Recovery of Collection Directive, Art. 20 (1)
[109] Recovery of Collection Directive, Art. 20 (2)
[110] Recovery of Collection Directive, Art. 22 (1)

4.5.2.4 Intermediate Remarks

In contrast in the EU, there is no equivalent rules in Indonesia regulating recovery of tax claims. This means, tax that cannot be imposed in Indonesia will not be guaranteed to be recovered in other countries. The power possessed by Indonesian tax authority and the authority of other state who has tax cooperation in Indonesia is limited have also resulted in the loss of potential tax revenue.

The non – existence of Recovery of Collection rules in Indonesia brings uncertainty for the tax authority and most importantly for the state itself. Indonesia should consider to provide legal framework on this matter to ensure the needs to safeguard tax revenue in Indonesia. The urgency of having the rules that covers recovery of collection rules will be crucial once Indonesia is involved in cross-border transactions and when Indonesia establish a tax treaty with another country.

4.5.3 The Automatic Exchange Directive

"Proper tax assessment and recovery of tax claims in cross-border situation call for cooperation and especially exchange of information among the tax authorities of the states concerned".[111] As mentioned earlier, the countries in European Union have reached certain minimum standard of law enforcement in addressing Double Taxation problem within European Union by helping each other through the mutual assistance directive. Since 25 January 1988, there had been Convention on Mutual Administrative Assistance in Tax Matters, which has been signed and ratified by certain Member States.[112] This Council Directive 2014/107/EU of 9 December 2014 is amending Directive 2011/16/EU concerning mandatory automatic exchange of information in the field of taxation. Following the negotiations between United States and all Member States regarding FATCA, OECD released the global standard package for automatic exchange of financial account information in tax matters. Council Directive 2011/16 EU has already provided mandatory automatic exchange information between Member States, but the rapid growth of cross border transactions has made the existing Directive less effective in combating tax fraud and evasion.[113]

The Objective of Automatic Exchange Directive

The increasing number of unreported and untaxed income because of cross-border tax fraud and tax evasion resulting reduced national tax revenues have forced an enhancement in efficiency and effectiveness of tax collection. To minimize the cost and administrative burdens, Automatic Exchange Directive ensures expanded scope of automatic exchange of information within the Union by requiring Financial Institution in every Member States to implement reporting and due diligence rules. However, there will be category for Financial Institutions that are considered as low risk of being used to evade tax should be excluded for the list of financial institutions that are required to implement this Directive. The implementation of this Directive will also limit the opportunity of taxpayers of being reported on shifting assets to Financial Institutions that are not on the scope of this Directive. The mechanism on processing the information under this Directive will be proportionate to enable

[111] Maarjana Helminen, *EU Tax Law Direct Taxation,* (2013) IBFD
[112] Maarjana Helminen, *EU Tax Law Direct Taxation,* (2013) IBFD
[113] Council Directive 2014/107/EU of 9 December 2014 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation (Automatic Exchange Directive)

Member States' tax administrations to use the information effectively in order to address the situation where taxpayers might hide capital or evading the tax, but not to initiate unnecessary investigation.[114]

4.5.3.1 Procedure

Article 3 point 9 of the Directive 2011/16/EU is amended by Article 1 in this Directive, which explains:
"'Automatic exchange' means the systematic communication of predefined information on residents in other Member States to the relevant Member State of residence, without prior request, at pre-established regular intervals. In the context of Article 8, available information refers to information in the tax files of the Member State communicating the information, which is retrievable in accordance with the procedures for gathering and processing information in that Member State."

4.5.3.2 The Cost

To minimize the costs and administrative burdens, it is necessary for the Member States to require their Financial Institutions to implement reporting and due diligence rules. Member states are anticipated to have one single list of domestically-defined Non-Reporting Financial Institutions and Excluded Accounts.[115]

4.5.3.3 Intermediate Remarks

Unfortunately, automatic exchange of information is not mentioned in Indonesian Mutual Agreement Procedure. The term of "Automatic" which in EU is defined as 'without prior request' is not recognized in Indonesian legal framework. As previously explained, the concept of MAP in Indonesia only regulates transfer pricing, dual residence, and APA issues which leads to narrowed interpretation of cross-border transactions. This condition causing many form of cross-border transactions that cannot be covered by this rules.

In addition, the long process of requesting the information in Indonesian MAP has been an impediment of the optimal information exchange. The absence of "automatic" concept in Indonesian MAP makes the implementation of the rules ineffective.

4.6 Developing Countries Face Policy Issues and Implementation Challenges

The report form G-20 Summit prepared by International Monetary Fund (IMF), OECD, UN and the World Bank stated that developing countries are facing practical difficulties in implementing transfer pricing rules. The difficulties are: "(a) in drafting clear legislation and guidance; (b) in building tax administration expertise and experience in transfer pricing to enable them to carry out effective audits; (c) in obtaining the information needed from taxpayers in order to select cases for audit or carry out effective audits; and (d) in obtaining public information on arm's length conditions, *i.e.* the conditions (for example, price or profit margin) in place for

[114] Automatic Exchange Directive, para. 9-10
[115] Automatic Exchange Directive, para. 9

independent enterprises conducting comparable transactions under comparable circumstances."[116] These difficulties were also face by developed countries, but the problems are "more acute" for developing countries.

One of the problems faced by developing countries in implementing transfer pricing which are the difficulties in obtaining information from taxpayers by developing countries in implementing transfer pricing rules and other tax evasion issues could be solved by implementing the mutual assistance policy since it will force tax authorities from states included in bilateral tax treaties to work together and assist other related tax authority in sending tax-related information regarding taxpayers. However, implementing the mutual assistance, recovery of tax claims and savings directives will most likely bring its own challenges.

The application of mutual assistance can be different from one state to another state. The different result depends on the "speed of reaction and the practices of its own tax administration."[117] There are several factors that influence the attainment of the mutual assistance in bilateral agreements. The first is the "Practical Factors", the second one is the "Legal Factors", the third one is the assurance of reciprocity, and lastly, the capacity of developing country's tax authority to obtain information.

4.7 The Practical Factors

There are variants of agreements in taxation, they could be bilateral agreements and multilateral conventions, and the most functioning conventions are those formed within closer jurisdiction, because the closer one country with other countries geographically, it tends to be the more active the cooperation. When one state is unaccustomed with the other contracting state's legal system and procedure, it will lead to create obstacle in achieving effective cooperation.[118] Or in other words: "In fact, the greater problem often is not differences in legal systems, but misunderstandings about those differences. In many instances, differences in systems can be overcome if both States make a concerted effort to carefully and fully explain the niceties of their laws to each other. Equally important, States should make inquiries about the other country's legal systems whenever there is a doubt."[119]

4.8 Legal Factors: Quantitative and Qualitative Inadequacy of the Regulations[120]

The secretive and complex bureaucracy and also administration system had been problematic obstacles that hinder countries concluded in tax treaties achieving the

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[116] A Report to the G-20 Development working group by The IMF, OECD, UN and World Bank, *Supporting the Development of More Effective Tax Systems",* (2011), p. 34

[117] María Amparo Grau Ruiz, *Mutual Assistance for the Recovery of Tax Claims,* (2003), Kluwer Law International, p. 155

[118] María Amparo Grau Ruiz, *Mutual Assistance for the Recovery of Tax Claims,* (2003), Kluwer Law International, p. 155

[119] Bernard Rabatel, '*Legal Challenges in Mutual Legal Assistance'* in *Denying Safe Haven to the Corrupt and the Proceeds of Corruption: Enhancing Asia-Pacific Cooperation on Mutual Legal Assistance, Extradition and Return of the Proceeds of Corruption-Capacity Building Program, Asian Development Bank (ADB)-OECD Anti-Corruption Initiative for Asia and the Pacific*, (2006), p. 39

[120] María Amparo Grau Ruiz, *Mutual Assistance for the Recovery of Tax Claims,* (2003), Kluwer Law International, p. 155

goal.[121] Another common issue in developing countries is the inadequacy of the legislation to counter tax avoidance. Taxpayers and tax authorities often encounter numerous amount of legislation that is not clear in wording or not specifically explain the coverage on what tax should be covered creating legal uncertainty, or when a regulation provides that a transaction should not be done, however it does not regulate the other alternative transaction, the regulation will likely be insufficient.

4.9 Assurance of Reciprocity

Mutual assistance tends to be contemplated as a reciprocal settlement of disputes compared than as a effort that is done collectively to enhance the adequacy and harmony of domestic taxation when applied in cross-border transaction.[122] However, when a bilateral treaty is concluded between developing country and developed country, it creates asymmetrical situation since the investment flows in only one direction.[123] Regarding the flow of exchange of information, considering that there will be additional cost that arises as to implementing new systems to keep the exchange of information effective, "It is important in this regards that the connection between exchange information and the allocation of taxing rights in highlighted to put developing countries into a more powerful negotiation position vis-à-vis developed countries in a tax treaty negotiation"[124] and that developing countries need to come up with greater effort in arguing the allocation of taxing right to reduce the asymmetry.[125]

4.10 The Essential Elements of Transparency And Exchange of Information

The essential elements of transparency and exchange of information that have been developed by the OECD are contained in the Article 26 of the OECD Model Tax Convention and the 2002 Model Agreement on Exchange of Information on Tax Matters.[126] They are: "THE 10 ESSENTIAL ELEMENTS OF TRANSPARENCY AND EXCHANGE OF INFORMATION FOR TAX PURPOSES:

A. AVAILABILITY OF INFORMATION
A.1. Jurisdictions should ensure that ownership and identity information for all relevant entities and arrangements is available to their competent authorities.
A.2. Jurisdictions should ensure that reliable accounting records are kept for all relevant entities and arrangements.
A.3. Banking information should be available for all account-holders.

B. ACCESS TO INFORMATION

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[121] María Amparo Grau Ruiz, *Mutual Assistance for the Recovery of Tax Claims,* (2003), Kluwer Law International, p. 155
[122] María Amparo Grau Ruiz, *Mutual Assistance for the Recovery of Tax Claims,* (2003), Kluwer Law International, p. 155
[123] María Amparo Grau Ruiz, *Mutual Assistance for the Recovery of Tax Claims,* (2003), Kluwer Law International, p. 155
[124] Raffaele Petruzzi and Karoline Spies, *Tax Policy Challenges in the 21st Century,* (2014), Linde Series on International Tax Law Michael Lang (ED), p. 543
[125] Raffaele Petruzzi and Karoline Spies, *Tax Policy Challenges in the 21st Century,* (2014), Linde Series on International Tax Law Michael Lang (ED), p. 542-543
[126] The Global Forum on Transparency and Exchange of Information for Tax Purposes, OECD, (2012), p. 7

B.1. Competent authorities should have the power to obtain and provide information that is the subject of a request under an EOI agreement from any person within their territorial jurisdiction who is in possession or control of such information.
B.2. The rights and safeguards that apply to persons in the requested jurisdiction should be compatible with effective exchange information.

C. EXCHANGING INFORMATION
C.1. EOI mechanisms should provide for effective exchange of information.
C.2. The jurisdictions' network of information exchange mechanisms should cover all relevant partners.
C.3. The jurisdictions' mechanisms for exchange of information should have adequate provisions to ensure the confidentiality of information received.
C.4. The exchange of information mechanisms should respect the rights and safeguards of taxpayers and third parties.
C.5. The jurisdiction should provide information under its network of agreements in a timely manner."[127]

4.11 Capacity of Developing Country's Tax Administration is Limited

There are several issues regarding tax administration in developing countries in Indonesia, particularly the tax authority. The tax authorities, who '*woefully inadequate*'[128] are facing many priorities in their job desk. The second issue is they are employers who are unfamiliar with international tax avoidance issue and constantly preoccupied with private sector, especially the large accountancy firms. This issue brings pressure to the tax authorities, compounded with lack of experience, creating an asymmetry situation when the tax authorities are challenged by well-prepared large companies. Furthermore, the government in developing countries may not have establish practice for the tax authority when they are settling the disputes with large taxpayers related to complex international cross-border transaction.[129] Learning from developed countries, where disputes occasionally settled with discussion and arrangement between tax authorities and taxpayers, it is not necessarily overcome the disputes in developing countries. Additionally, when a tax authority is granted with wide discretion, what is potentially could happen is there will be a larger opportunity for corruption.[130]

There are several aspects of domestic law mentioned in UN Model regarding Double Tax Treaty which may be relevant to Indonesia's tax administration at the moment which are:

1. "Is there enough international tax expertise in the units dealing with international tax matters?
2. Are there enough resources available to apply tax treaties?

[127] The Global Forum on Transparency and Exchange of Information for Tax Purposes, OECD, (2012), p. 7-8
[128] Report of OECD : Part 1 of a Report to G20 Development Working Group on The Impact of BEPS in Low Income Countries, (2014), p. 13
[129] Report of OECD : Part 1 of a Report to G20 Development Working Group on The Impact of BEPS in Low Income Countries, (2014), p. 13
[130] Report of OECD : Part 1 of a Report to G20 Development Working Group on The Impact of BEPS in Low Income Countries, (2014), p. 13

3. Should certain international tax matters be dealt with by local units or by specialized units (such as, for instance, taxation of non-residents by assessment and decisions to allow withholding agents to provide tax treaty benefits at source)?
4. Are there sufficient language skills in the units dealing with international tax matters?
5. Is there a separate fiscal intelligence unit for gathering and distributing relevant tax information on international tax matters?"[131]

[131] Jan J.P. De Goede, *Taxation of Investment Income and Capital Gains,* in United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries, (2013), p. 305

5. Conclusion

Every country that enters double tax treaty should be attentive to examine the probability and the consequences of entering tax treaty because they potentially create opportunities for tax avoidance. Another issue that will likely arise is the improper use or abuse of tax treaties.

United Nations and OECD have tried to prevent double taxation and double non taxation issues by their model convention which each member of the organization may adapt. However, double taxation and double non – taxation issue will remain exist since every country has different legislation and tax rates. What is left is room for improvement.

Beside Information Exchange Directive, EU member states adopt Recovery of Collection Directive which enables authorities from other contracting state in the tax treaty to recover tax claim from or take precautionary measures to guarantee the recovery of these claims and the Savings Directive which provide tax authorities from other state greater authorization to ensure tax collection is optimal.

In the mean time, Indonesian's tax regulation regarding cross-border transaction and its tax treaties are still premature. There has been no significant development since its first tax reformation in 1983. One of the major aspect of the lesson from European Union's Directives is the automatic exchange of information. Indonesian mutual agreement procedure only recognizes exchange of information without requiring the automatic exchange of information. This procedure plays important role n the enforcement of the exchange of information, particularly to ensure the information collection is effective and efficient.

The aim of the study is to establish what Indonesia could learn from with EU, and it has been established in this study that there are some aspects in Indonesia that are not regulated yet, or needs to be further elaborated, and the regulation itself could be more explicit on defining every transaction in cross-border transactions which accordingly will leave no room for loopholes resulting in Indonesia loosing the right to tax, loosing its revenue, or it could also lead to non-double taxation.

The next step is to cut out unnecessary steps in the bureaucracy that creates a very long process of assessing whether one request of exchanging information should be granted or not. Another thing that needs to be done is to make a decision on the issue of bank secrecy that has been an impediment to the lack of tax collection system in Indonesia.

The concept of automatic exchange of information directive, savings directive, and recovery of collection directive in EU has been a clear example of how important is the certainty in legal framework. Without the existence of automatic exchange of information rule, savings rule, and recovery of collection rule in Indonesia as well as a clear concept of mutual agreement procedure, it will be difficult to reach the goal to safeguard the state's revenue from tax.

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