BRANCH PROFIT OF UPSTREAM OIL AND GAS BASED ON TAX TREATY AND PRODUCTION SHARING CONTRACT IN INDONESIA

Maria R. U. D. Tambunan
Fakultas Ilmu Administrasi, Universitas Indonesia
email: maria.tambunan@ui.ac.id

disampaikan 09/03/2023 – di-*review* 18/03/2024 – diterima 02/06/2024
DOI: 10.25123/vej.v10i1.6538

Abstract
Tax treatment for a production sharing contract (PSC) is possibly different from general tax rules when calculating the amount of annual cost to be allocated by upstream oil and gas business to project their profit. On the other hand, the prevailing tax law applied in a particular country could either be made based on domestic tax law and a tax treaty depends on the tax subject. This article is intended to discuss tax arrangements sourced by a PSC during cost recovery regime and tax treaties in Indonesia. This study also discusses the cases brought before the Supreme Court due to the interplay of a PSC and a tax treaty during the years of 2015-2021. The research uses normative legal research with data collected through documentation studies. The contractors demanded a reduced tax rate on branch profit derived from a tax treaty as a general rule considering that they are the persons covered by the treaty. However, they must also respect production sharing as agreed in a PSC that existed before the conclusion of the tax treaty. For the future, it needs to adopt the stabilization clause to deal with the issue.

Keywords:
branch profit tax; production sharing contract; tax treaty; withholding tax

Abstrak
Pengenaan pajak dalam kontrak bagi hasil (KBH) dapat saja berbeda dengan ketentuan pajak umum ketika menghitung besar biaya yang dikeluarkan oleh industri hulu migas di setiap tahunnya untuk memproyeksikan keuntungan. Di sisi lain, ketentuan pajak yang berlaku di suatu negara berasal dari hukum domestik dan perjanjian penghindaran pajak berganda (P3B) sesuai subyek hukumnya. Penelitian ini membahas pengenaan pajak yang bersumber dari KBH dan P3B untuk industri hulu migas pada masa generasi KBH *cost recovery*. Penelitian ini juga membahas berbagai sengketa yang dibawa ke pengadilan pajak akibat dualisme ketentuan pajak yang bersumber dari P3B dan KBH dalam kurun waktu 2015-2021. Penelitian ini menggunakan metode hukum normatif dengan studi kepustakaan dan dokumentasi. Kontraktor migas pada dasarnya menginginkan tarif yang lebih rendah atas pengenaan *branch profit tax* yang bersumber dari P3B mengingat bahwa entitas tersebut adalah subyek pajak yang berhak atas manfaat P3B. Namun terdapat KBH yang telah disepakati dan harus dipatuhi di mana KBH tersebut telah disepakati sebelum hadirnya P3B. Di masa mendatang, klausa stabilisasi dibutuhkan untuk mencegah timbulnya permasalahan.

Kata Kunci:
branch profit tax; kontrak bagi hasil; perjanjian penghindaran pajak berganda; *withholding tax*

Introduction

Taxation is a crucial cost factor for foreign investors, as it directly relates to their ability to conduct business in the host country. The tax burden is aligned with the income generated from their production and commercial activities.[1] Investors must also account for taxes on capital income, including dividends, branch profits, interest, royalties, and income from active business operations.[2] The host country's tax policy serves as a crucial tool for generating revenue, which is vital for supplying public goods, and also acts as a mechanism to regulate the behavior of foreign investors.[3]

There have been ongoing disputes between the Indonesian Government and upstream businesses regarding the application of a reduced rate for a tax treaty, a double tax agreement (DTA) on branch profit tax, and the calculation of cost recovery.[4] This issue was distinguished and discussed by the stakeholders when the Special Task Force for Upstream Oil and Gas Business Activities held a national tax forum in 2015.[5] The forum failed to resolve or prevent disputes regarding the use of non-litigation solutions in many court cases. The application of reduced tax rates under tax treaties for branch profits transferred to headquarters is a major issue, particularly concerning the extent to which foreign upstream businesses can apply these reduced rate.[6]

The potential dispute began when the Indonesia's National Government Internal Auditor (or *Badan Pengawas Keuangan dan Pembangunan*) – "BPKP" discovered that the percentage of the government's profit from the oil and gas sector had not fulfilled the net percentage of the amount that it should have earned from this business, i.e. 85% (government) and 15% (business)[7] as agreed in the plan of

---

1 Burns, Lee, and Richard Krever. "16 Taxation of Income from Business and Investment". In *Tax Law Design and Drafting, Volume 2*, (USA: International Monetary Fund, 1998) accessed May 10, 2022, https://doi.org/10.5089/9781557756336.071.ch016

2 Jaja Zakaria, Perlakuan Perpajakan terhadap Bentuk Usaha Tetap, (Jakarta: PT. Raja Grafindo Persada, 2007), p. 107.

3 Abba Kolo, Thomas W. Wälde, 'Investor-State Disputes: The Interface Between Treat-Based International Investment Protection and Fiscal Sovereignty', (2007), 35, Intertax, Issue 8, pp. 424-449, https://kluwerlawonline.com/journalarticle/Intertax/35.8/TAXI2007049

4 The dispute has been presented annually to the tax and supreme courts since it became public. The most recent ruling from the tax court was issued at the start of 2020 (Put-096970.13/2011/PP/M.VIIIA/ 2019) and at the end of 2020 for the supreme court (Putusan No. 368/B/PK/Pjk/2020).

5 In November 2015, the Special Task Force for Upstream Oil and Gas Business Activities held the "National Tax Forum" to address issues faced by upstream businesses. Participants included the tax authority, Secretary of Directorate of Oil and Gas, Ministry of Energy and Mineral Resources, Directorate of State Budget, Ministry of Finance, Upstream Business, Indonesia National Oil Company, Academia and Civil Society. A key issue identified was the withholding tax on branch profits remitted by foreign upstream businesses in Indonesia to their headquarters.

6 Between 2017 and 2020, the researcher noted over 40 disputes between Indonesian tax authorities and foreign businesses were brought before the tax and supreme courts (i.e. Tax Court Decision No. PUT-096970.13/2011/PP/M.VIIIA year 2019), Malaysia (i.e. Tax Court Decision No. Put-87275/PP/M.IIA/13/2017), United Kingdom (i.e. Tax Court Decision No. 435/B/PK/Pjk/2020) and Norway (i.e. Tax Court Decision No. 3143/B/PK/Pjk/2018).

7 In 2011, Indonesia's National Government Internal Auditor, Badan Pengawas Keuangan dan Pembangunan (BPKP), identified a potential tax dispute involving upstream oil and gas businesses. BPKP discovered discrepancies in the tax

development (PoD) – technical guidance for a production sharing contract (PSC).[8] In 2014, upstream businesses were found to have underpaid taxes totaling IDR 1.12 billion. Underpaid tax is an issue that has frequently recurred. This problem emerged when the government insisted on applying the PSC tax treatment as a special law, conflicting with businesses' views that they were entitled to tax benefits under the DTA.[9]

The audit findings on the BPKP opinion revealed that despite some tax treatments potentially favoring businesses, the specific "stabilization clause" (85%:15%) in the PSC needed to be strictly applied as agreed between the businesses and government.[10] Consequently, following the underpayment highlighted by the BPKP audit, the Directorate General of Taxes (DGT) issued underpayment notices to several oil and gas upstream businesses.[11] Meanwhile, the general tax rule mandates that withholding tax on branch profits should adhere to the DTA with the business's resident country. The issue escalated public interest after the Indonesian Corruption Eradication Agency revealed government officials' involvement in sanctioning tax avoidance strategies regarding reduced withholding taxes on branch profits. Public disclosure of these cases aided the tax authority in clarifying the dispute's core issues.[12]

Discrepancies between tax authorities and taxpayers often arise due to several factors: 1) limited understanding or varying interpretations of tax laws and formal documentation by taxpayers or auditors; 2) differences in commercial versus

calculations performed by these businesses and the Special Tax Force for Upstream Oil and Gas Business Activities of the Republic of Indonesia. See, Detik Finance, Perusahaan Migas dan BPKP Beda Hitungan soal Tunggakan Pajak, (2011), retrieved from https://finance.detik.com/energi/d-1685108/perusahaan-migas-dan-bpkp-beda-hitungan-soal-tunggakan-pajak- at 14th January 2021.

8 The BPKP is authorized to audit Indonesia's upstream oil and gas sectors, ensuring compliance with regulations on public finance, state assets, and natural resource management as outlined in Law No. 22 of 2001 and Presidential Regulation No. 192 of 2014, https://www.bpkp.go.id/konten/1/Tugas-dan-Fungsi.bpkp.

9 Badan Pemeriksa Keuangan, Badan Pemeriksa Keuangan Temukan Masalah Pajak Minyak dan Gas Bernilai Rp. 1,12 Triliun,(2014), retrieved from https://jdih.bpk.go.id/wp-content/uploads/2015/05/BPK-Temukan-Masalah-Pajak-Migas-Bernilai-Rp-112-Triliun.pdf.

10 In 2011, the BPKP sent the underpayment statement on tax obligation to several upstream businesses for fiscal years 1991-2008.

11 Nadia Kurnia, Tiga Perusahaan Migas Tunggu SKP untuk Bayar Pajak, (2011), retrieved from https://ekonomi.bisnis.com/read/20110720/44/42922/3-perusahan-migas-tunggu-skp-untuk-bayar-pajak at 14th January 2021.

12 Chandra Budi, Mengakhiri Polemik Pajak Migas, (2008), retrieved from https://www.pajak.go.id/artikel/mengakhiri-polemik-pajak-migas at 14th January 2021.

fiscal accounting records; 3) interpretations of ambiguous areas that may create loopholes; and 4) vested interests influencing each party's behaviour.[13]

The objective of this study is to discuss the tax arrangement regulated by the PSC and DTA and to elaborate cases stipulated by the tax court and supreme court with regard to issues of tax treatment on branch profit remitted by the permanent establishment of foreign upstream business operated in Indonesia. The discussion uses comparisons with several countries such as the Netherlands, UK, Malaysia, and other countries. This research uses normative legal research with data collected through documentation studies. The contractors demanded a reduced tax rate on branch profit derived from a tax treaty as a general rule considering that they are the persons covered by the treaty. It will present the facts and the intention of each contracting party. In addition, this article also discusses the interplay of tax treatment on the PSC and the contract between the government and the business as well as the tax treatment as agreed by the competent tax authority.

Analysis

Indonesia Production Sharing Contract and the Position of Taxation Rule

A production sharing contract allows a contractor to recover up to 40% of expenses from extracted resources, termed 'cost oil.' The remaining 60%, 'profit oil,' is split according to a set ratio, often favoring the government. After initial costs are recovered, the 'cost oil' percentage lowers to cover only operational costs, thereby increasing the 'profit oil' share.[14] Indonesia's Production Sharing Contract (PSC), initiated in 1964 under Law No. 44 of 1960, addresses limitations in capital, technology, and expertise for oil exploration. It ensures state participation and oversight while allowing contractors autonomy in operations and decision-making. The 30-year PSC enables contractors to project costs and develop effective business strategies:[15]

---

13 Muhsin, Muslih, "*Badan Penyelesaian Sengketa Pajak Setelah Berubah Menjadi Pengadilan Pajak:, makalah disampaikan pada Sosialisasi Undang-undang Pengadilan Paiak sebagai Pengganti Undangundang Badan Penyelesaian Sengketa Pajak*", Jakarta, April 2002

14 Kamal Hossain, Law and Policy in Petroleum Development: Changing Relations between Transnationals and Governments, (London: Francis Publishers Ltd,) pp. 110.

15 Arba Maulana, Penerapan Asas Proporsonalitas dalam Production Sharing Contract pada Kegiatan Usaha Pembangunan Pertambangan Hulu Mogas dan Gas Bumi. Diponegoro Law Review, (2016), Vol. 5, No. 2; Rinto Pundyantoro, A to Z Bisnis Hulu Migas, (Jakarta: Petromindo, 2012), p. 163. Further, the Constitution of the Republic

a) The contractor contributes all required funds and assumes all risk;
b) The operation is managed by the Indonesian Government (in practice, it must be realized by the Special Task Force for Upstream Oil and Gas Business Activities, Republic of Indonesia or *SKK Migas)*; and
c) Ownership of minerals remains within the state until the moment of delivery.

The PSC's tax terms require contractors to comply with Indonesian tax laws, including income and post-profit taxes, with provisions adapting to the economic climate during exploration. This ensures contractors' adherence to tax filings, assessments, and record-keeping as mandated by Indonesian regulations.[16]

a) Pre Indonesia Tax Reform (before year 1984)

Under the 1925 Company Tax Ordinance, Indonesia PSC taxation included two periods:

1. Prior to Finance Minister Decree No. 267/KMK.012/1978, contractors calculated net operating income (NOI) from oil and gas, deducting up to 40% for cost recovery. Profit sharing between the state (through Pertamina) and contractors was typically 85:15. The 85% assumed all government taxes and levies, making the 15% the contractor's net after-tax income.
2. Since 1978, the profit split changed to approximately 66% for the government and 34% for contractors. This calculation considered a gross-up for taxes, with contractors' total taxable income at 34.09%, including a 19.09% tax. Pre-1984 tax laws included the 1925 Ordinance, the PBDR Act of 1970, the 1940 Income Tax Ordinance, and the 1932 Wealth Tax Law.

b) 1984 (beginning of tax reform) until 1994

of Indonesia in 1945, Art (33) stated that "All the natural wealth on land and in the waters falls under the jurisdiction of the State and should be use for the greatest benefit and welfare of the people".

16 Nurmala Manik, Kajian Pengenaan Pajak Penghasilan atas Sektor Migas di Indonesia, Master Thesis, Department of Administrative Science, Faculty of Social and Political Science, Universitas Indonesia, (2003), pp. 80-90.

Under Indonesia's Income Tax Law No. 7/1983, income from oil, gas, and mining contracts made before January 1, 1984, is taxed according to the 1925 Corporate Tax Ordinance and the 1970 Tax Law. The 1983 law adopted a "nail down" approach, fixing tax provisions at the contract's inception. Post-1983, the income tax rate rose to 35%, impacting the government's and contractors' shares. Contractors' after-tax profit share is 15%, with recalculated tax obligations to preserve government entitlements despite tax rate changes.

c) After year 1994

Indonesia's 1994 Income Tax Law, effective from January 1, 1995, altered how contractors' shares are calculated, ensuring government rights are not diminished despite a reduced income tax rate to 30%. Existing contracts at the law's onset remain taxed under their original terms. The contractor's net share adjusted to 26.97% and government's to 73.22% after gross-up recalculations, with the total tax at 44%. Tax due by contractors is 11.78%, yielding a taxable income of 26.78% for contractors and 73.22% for the government, respecting the 85:15 revenue sharing agreement.

Table 1. Percentage of Revenue Sharing between Contractors and Government

Notes	Ord. PPs 1925	Law No.7/1983		Law No. 10/1994	Law No. 17/2000
	Before 1984	1984	1991	1994	2001
Corporate Tax	45%	35%	35%	30%	30%
Dividend Tax (PBDR) (PBDR x (100% - Corporate Tax)	11%	13%	13%	14%	14%
Total Tax	56%	48%	48%	44%	44%
Net Contractor (after tax)	44%	52%	52%	56%	56%
B. Calculation of Indonesian and Contractor Portion					
Contractor Portion	15%	15%	15%	15%	15%
Contractor gross	15%/44%	15%/52%	15%/52%	15%/56%	15%/56%
Taxable income contractor (100/net contractor after tax x contractor portion)	34,09%	28,85%	28,85%	26,78%	26,78%
Government entitlement	65,91%	71,15%	71,15%	73,22%	73,22%
Contractor tax	19,09%	13,85%	13,85%	11,78%	11,78%
Indonesia entitlement	85%	85%	85%	85%	85%

Source: Tax Court Decision No. PUT-102925.36/2011/PP/M.XIIIA year 2019

In the Indonesian PSC system, profit sharing from oil and gas production follows predetermined contract terms. The system has evolved through several revisions, mainly due to tax disputes and demands for clearer terms. Accurate agreements are essential to prevent disputes and assess tax liabilities. Debates often arise from double taxation agreements and their impact on profit remittances to businesses' home countries, focusing on branch profit taxes and government shares. Comparisons of government revenues before and after such tax adjustments are available in a table.

Table 2. The Comparison of Total Government Revenue with and without Reduced Rate

	Revenue Split with Branch Profit Tax 10%			Revenue Split with Branch Profit Tax 20%	
No.	Description	Oil	Gas	Oil	Gas
1.	Gross contractor share	67.3077%	76.9231%	67.3077	76.9231%
2.	Corporate tax = 35%	23.5577%	26.9321%	23.5577%	26.9231%
3.	Contractor's Income after tax (1-2)	43.75%	50.00%	43.75%	50.00%
4.	Branch Profit Tax (BPT) = 15%	4.38%	5.00%	8.75%	10.00%
5.	Net Contractor share (3-4)	39.38%	45.00%	35.00%	40.00%
6.	Total tax (2+4)	27.93%	31.92%	32.31%	36.92%
7.	Government revenue share	32.6923%	23.0769%	32.6932%	23.0769%
8.	**Total government revenue share (6+7)**	**60.62%**	55.00%	**65.00%**	60.00%

Source: Tax Court Decision No. PUT-102925.36/2011/PP/M.XIIIA year 2019

The Feature of Double Tax Agreement (DTA) and Branch Profit Tax

A tax treaty or Double Tax Agreement (DTA) assigns tax rights between two countries to prevent double taxation on cross-border income.[17] DTAs determine which country has taxing rights over a multinational company's operations and should align with, but not override or create, domestic tax laws.[18] When drafting Double Taxation Agreements (DTAs), countries need to align them with their own tax laws to ensure consistency. Since changes in domestic law usually do not affect DTAs, it is important to handle tax law reforms and DTA amendments simultaneously to maintain treaty effectiveness.[19]

[17] The OECD defined double taxation as "the phenomenon of international double taxation, which 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".

[18] OECD, Tax Treaty Design for Resources-Rich Developing Countries. Retrieved from https://www.oecd.org/dev/Session_1_%20Tax_Treaty_Design%20for_Resource-Rich_Countries_Zero_Draft.pdf on 24 September 2021.

[19] Id., supra note 17.pp. 2

Under a tax treaty, tax liability in a country hinges on one's residency status. Residents are taxed on worldwide business profits, whereas non-residents are only taxed on income from sources within that country or linked to a permanent establishment there.[20] Tax residency in Indonesia is determined by domestic law, considering domicile and incorporation place. Under double tax agreements, a tie-breaker rule avoids double taxation in cases of dual residency.[21] Indonesian law taxes non-residents on interest, dividends, and royalties at domestic rates, per Article 26, with possible reductions under tax treaties.[22] Article 26(4) stipulates that income from Indonesian permanent establishments is subject to a 20% withholding tax unless reinvested locally, details to be specified by the Ministry of Finance[23]. Indonesia's DTAs often address the taxing rights on profits from permanent establishments and dividends, typically allowing a withholding tax below the domestic rate of 20%, shared with treaty partners.[24]

According to the 2017 revision of the OECD Model Tax Convention, Article 10(2) defines dividends as income from various share types and profit-participating rights, excluding debt claims, taxed by the resident company's country. This article also permits the resident company's state to tax dividends but caps this at a negotiated percentage of the gross amount if the owner is a company resident in another state.[25]

In Indonesia, income from a non-resident entity's permanent establishment is taxed similarly to a local entity under Indonesian rules. After corporate income tax, any profit transferred as dividends to the home jurisdiction is subject to a withholding tax.[26] PricewaterhouseCoopers notes the distinction between

---

20 Article 5 OECD Model Tax Convention's (MTC) latest amendment in 2017 defined a permanent establishment as "a fixed place of business through which the business of an enterprise is wholly or partly carried on. The term permanent establishment includes especially (a) a place of management, (f) **mine, an oil or gas well, a quarry or any other place of extraction of natural resources".**

21 OECD, Are the Current Treaty Rules for Taxing Business Profit Appropriate for E-Commerce? Final Report, Centre for Tax Policy and Administration, https://www.oecd.org/tax/treaties/35869032.pdf (accessed at 17 February 2022).

22 Rachmanto Surahmat, Persetujuan Penghindaran Pajak Berganda: Suatu Kajian terhadap Kebijakan Indonesia, Indonesia, Salemba Empat, (2011).

23 Art. 10 of UN MTC and OECD MTC referred to the agreement on the allocation of taxing rights on dividends and similar patterns.

24 Rachmanto Suharmat, id., p. 96.

25 Refers to Art. 10(2) regarding Dividend of UN MTC, retrieved from https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf.

26 Explanatory to the Indonesia Income Tax Law, Art. (2) mentioned that, for a foreign tax subject that is operating a business or undertaking economic activities through a permanent establishment, the fulfilment of its tax obligation shall be treated as if the domestic tax subject (Indonesian tax resident) is adhering to the Indonesia Income Tax Law and Indonesia General Procedure Law.

dividends (profit distribution) and branch profit (profit remittance) based on the entity's legal structure, with both foreign branches and subsidiaries being subjected to Indonesian corporate income tax.[27] Under a Double Tax Agreement (DTA) following the OECD Model Tax Convention, capital income (interest, dividends, royalties) is primarily taxed in the investor's home country, but the host country may also levy a withholding tax up to the treaty-specified maximum rate.[28]

Dispute on Branch Profit Tax Based on a Tax Court Decision

In the oil and gas sector, traditional tax rules often did not apply to PSCs due to their specialized nature, and tax authorities typically did not oversee these contracts' operations.[29] Tax duties for each PSC were not always detailed or consistent with other regulations. Historical contracts were based on outdated Dutch tax ordinances from 1925 and 1944, which differed from the 1983 tax reforms. Further, tax reforms in 1994, effective from 1995, required that existing PSCs comply with new tax obligations calculated per the original PSC terms,[30] and any existing tax regulations remained valid provided they did not conflict with the new law.[31]

The 1979 PSCs required mutual consent and written permission for any changes, preventing unilateral amendments and expecting good faith from all parties. From 2015 to 2021, tax and supreme courts in Indonesia resolved

---

27 PricewaterhouseCooopers explains that dividends represent income distribution, while branch profit remittances are exactly that—remittances of profit. Both are subject to a final withholding tax under domestic law, with dividends additionally subject to conditions under the tax-sparing rule". See, PricewaterhouseCoopers, Same Difference: Dividend and Branch Profit, retrieved from https://www.pwc.com/ph/en/taxwise-or-otherwise/2020/same-difference-dividends-and-branch-profits.html.

28 Refers to UN Model Tax Convention Art. 10(1) mentions that "Dividend paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State". Article (2) states that " However, ….., but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed (a) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) …..; (b) (b) ___ per cent (the percentage is to be established through bilateral negotiations) ……" See, UN Model Tax Convention Art. 10, retrieved from https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf.

29 Indonesian tax reform commenced in 1983, leading to the adoption of domestically drafted tax regulations and the termination of the inherited Dutch tax law.See PriceWaterhouseCoopers, The Urgency of Building Competitiveness to Attract Oil and Gas Investment, Jakarta, September 20015, pp 35-36.

30 Article 33A (4) Law No. 10 1994 regarding the income tax law mentioned, "Taxpayers who run businesses in the fields of oil and gas mining, general mining, and other mining based on Production Sharing Contracts, Contracts of Work, or mining business cooperation agreements that are still valid at the time this Law comes into effect, the tax is calculated based on the provisions in the Sharing Contract. The results, Contract of Work, or mining concession agreement until the end of the said contract or cooperation agreement."

31 Article (34) Law No. 10 1994 regarding regarding the income tax law mentioned "Implementing regulations in the field of Income Tax which are still in force at the time this Law comes into effect are declared to remain valid as long as they do not conflict with the provisions of this Law."

approximately 46 cases involving conflicts between tax treaties and PSC tax terms, with countries like Malaysia, the Netherlands, the UK, Norway, and Canada. Some taxpayer appeals were successful, while others were not.

The process for handling disputed cases is outlined subsequently:

a. The tax authority issues a notice for underpaid taxes following a BPKP audit, which shows government revenues from an oil and gas company were below expectations. The authority seeks to recover the shortfall based on BPKP's recommendations; it directs the Directorate General of Tax to collect the unpaid taxes and requests the Ministry of Energy and Mineral Resource to renegotiate the PSC to secure the government's share, especially when tax treaties affect revenue allocations.
b. The tax authority revises the withholding tax rate on branch profit tax during assessments, dismissing the lower rate used by contractors based on tax treaties with their head office countries. A 20% rate from the PSC is enforced, resulting in a demand for the contractors to pay the underpayment.
c. Contractors often argue for the reduced rate, stating there is no explicit clause in the PSC preventing its application. Adhering to the DTA, they claim the reduced rate should apply to the resident of the contracting state, and thus, they are entitled to this reduced rate.
d. Although Indonesian tax law mandates a 20% withholding tax on income remitted abroad, contractors have contested this rate, leading to disputes.

a) PSC and Tax Treaty Indonesia – the Netherlands

PSCs between Indonesia and Dutch contractors established from 1966 to 1978/79 were initially set for 30 years, with a 20-year renewal around 2009. The Indonesia-Netherlands tax treaty, effective from January 1, 2004,[32] capped the

[32] Agreement between the Government of the Republic of Indonesia and the Government of the Kingdom of the Netherlands, retrieved from https://www.pajak.go.id/id/p3b/belanda.

withholding tax on gross profits remitted to 10%,[33] contrasting with Indonesia's domestic rate of 20% in the PSCs.

The tax auditor's amendment aligned the withholding tax rate to 10% from the previous 20%, following BPKP's recommendation and the 1978 Ministry of Finance Regulation No. 267/KMK.012. This regulation stipulated a 20% tax on interest, dividends, and royalties as per the PSCs to clarify production shares between parties. However, contractors applying a reduced rate resulted in a lower government share in the production split, altering the typical 85% (government) to 15% (contractor) ratio.

During tax court appeals, contractors argued firstly that PSCs, like the 1979 version, did not expressly forbid applying the tax treaty's reduced rate for taxes on interest, dividends, and royalties. Secondly, they noted the PSCs did not mandate the government-contractor profit split to be 85%:15%; hence, a reduced rate altered this ratio to 83.125%:16.875%, without any outlined consequences or acknowledgement of this potential shift in the documents.

The judges stated that contractors should renegotiate the PSC when applying the tax treaty's reduced rate, not unilaterally enforce it without formal renegotiation before the contract ends. This issue, first raised in 1999 when the Dutch tax authority notified about the reduced rate, was unresolved until the tax court case. Additionally, any application of the stabilization clause, which underpins the production sharing proportion, should be clarified in negotiations. Despite the 85%:15% ratio not being specified in the PSC, the contractors were expected to understand this as a foundational term of their agreement. The judges thus dismissed the contractors' objections.[34]

---

33 Art. 10 (1) Indonesia – the Netherland DTA mentioned "dividend paid by by a company which is a resident of one of the two States to a resident of the other State may be taxed in that other State". Art 10 (2), "However, such dividends…., the tax so charged shall not exceed **10 per cent of the gross amount of the dividends".** Art. 10(5) define dividend means, "income from shares, "jouissance" shares or "jouissance" rights, founders' shares or other rights participating in profits, as well as income from debt-claims participating in profits and income from other corporate rights assimilated to income from shares by the taxation law of the State of which the company making the distribution is a resident".

34 The rejected objections are the following: (i) Tax Court Decision No. PUT-096970.13/2011/PP/M.VIIIA 2019, (ii) Tax Court Decision No. Put-82032/PP/M.VIIIA/13/2017, objected case fiscal year 2008, settled by the tax court in 2017, (iii) Tax Court Decision No. 82033/PP/M.VIIIA/13/2017, objected case fiscal year 2008, settled by the tax court in 2017, (iv) Tax Court Decision No. 82034/PP/M.VIIIA/13/2017, objected case fiscal year 2008, settled by the tax court in 2017, (v) Supreme Court Decision No. 4000/B/PK/Pjk/2019, (vi) Supreme Court Decision No. 368/B/PK/Pjk/2020, (vii) Supreme Court Decision No. Nomor 417/B/PK/Pjk/2018, (viii)

The Supreme Court accepted some objections, noting that if a PSC specifically addressed permanent establishment and related tax implications, its provisions should be upheld. The court found that PSC and DTA terms could coexist and, upon reviewing the audited financial reports, verified that the government-contractor production sharing ratio of 85%:15% was honored. Based on these findings, the judges ruled in favor of the contractors' appeals in certain cases.

b) PSC and Tax Treaty Indonesia – the United Kingdom

Tax court cases indicate that many 1982 PSCs between Indonesia and the UK included a permanent establishment. The attached PoD specifies a 85:15 government-contractor production share, achievable with a 20% withholding tax on profits sent to the contractor's home country. PSCs from early 1992/1993 were set to last 30 years, expiring around 2022/2023.[35]

The Indonesia-UK tax treaty, effective from January 1, 1995, was signed on April 5, 1993, with earlier treaties concluded before 1992/1993. PSCs mandate a crude oil production share of 71.1538% for Pertamina and 28.8462% for the contractor. Contractors owe a 35% income tax on net profits and a 20% tax on interest, dividends, royalties, or branch profits, in accordance with the tax regulations at the time of contract. These taxes ensure the government-contractor net share aligns with the 85:15 ratio.

The tax dispute arose when contractors were assessed for underpaying taxes, having applied a 10% reduced branch profit tax rate, claiming entitlement under a tax treaty. The tax authority insisted on full rates as specified by the PSC, which they saw as overriding domestic law and the tax treaty. The court ruled the PSC took precedence over the tax treaty, requiring contractors to honor the production sharing ratio and dismissing their objection.

In another context, judges offered differing interpretations for several comparable cases (decided through, for instance, Tax Court Decision No. PUT-091728.36/2010/PP/M.XIIIA 2018 and Tax Court Decision No. PUT-109140.36/2011/PP/MIIA 2018). They viewed the 85:15 production sharing as a

35 Cited from Tax Court Decision No. PUT-109140.36/2011/PP/MIIA year 2018

customary practice in the oil and gas sector. The judges noted that such a convention violated Civil Code Articles 1339 and 1347, which state that a convention can only apply if it has been explicitly enacted by the prevailing law. Moreover, the judges believed that the PSC did not clearly state the government's 85% and the contractor's 15% shares as legitimate entitlements. They also indicated that, as long as the withholding tax imposition did not exceed 10% as permitted by the tax treaty, such an action could be deemed acceptable.

In this case, the court determined that tax policy should not dictate the primary terms of production sharing distribution; instead, both parties must adhere to the contract terms. A 10% withholding tax was deemed compliant with tax law, and the judges upheld the contractors' objections. Furthermore, they advised renegotiating the contract to clarify and equitably establish the distribution terms, considering the evolving conditions.[36]

c) PSC and Tax Treaty Indonesia-Malaysia

The 1966 PSC with a Malaysian contractor, renewed in 1990 until 2016, followed the Dutch tax ordonnance and Law No. 8 of 1971 in Indonesia. Income tax on dividends, interest, and royalties faced a 20% withholding tax. The audit by BPKP revealed the contractor applied a reduced PDRB rate, leading to government underpayment. The tax authority issued an assessment letter for this underpayment, attributing it to a reduced branch profit tax rate on income sent to headquarters. Disputes escalated to tax and supreme courts.

To fulfil the tax obligation before the release of the underpayment of income tax assessment letter, the contractor referred to the Indonesia-Malaysia tax treaty that had allowed the application of a reduced rate withholding tax of 12,5% in the Protocol of Indonesia-Malaysia Article 4(c). It specifically mentioned that the tax treatment on branch profit tax on the after-tax profit for a permanent establishment may be taxed 12,5%.[37] The tax treaty between Indonesia and Malaysia was signed

36 The accepted objection by the Supreme Court (i) Supreme Court Decision No. 1432/B/PK/Pjk/2019 as the review to the Tax Court Decision No. Put.109140.36/2011/ PP/M.IIA year 2018, (ii) Supreme Court Decision No. Nomor 1992/B/PK/Pjk/2019 as the review to Tax Court Decision No. PUT-110339.36/2010/PP/M.VA of 2018, dated 30 July 2018, (iii) Supreme Court Decision No. 1992/B/PK/Pjk/2019 as the review.

37 The Protocol of Indonesia-Malaysia Double Tax Agreement Art (4) (c.) mentioned that "In connection with Article 7 "Business Profit", nothing in this Article shall prevent either Contracting State from imposing, apart from the

on 1 January 1987 and has been in effect since September 1991. The existence of this article and the provision agreed in the PSC seem to lead to unobvious tax treatment.[38] The contractor also argued during the tax court hearing that there was no explicit prohibition in the PSC to disallow the application of a reduced rate.[39] Thus, the tax authority should not request the fulfilment of their tax obligation following the tax authority calculation.

The judges ruled that tax treaties and the PSC's clear terms mandated a 20% withholding tax on interest, dividends, and royalties, as stated in the 1970 tax law, aligning with financial reforms since 1983 to provide certainty in extractive industry contracts. This upholds an 85:15 government-contractor production share, leading to the rejection of the contractor's objection.[40]

d) PSC and Tax Treaty Indonesia and Other Countries

Similar disputes also arose with contractors whose upstream business permanent establishments were in Norway and Canada. The PSC contains a specific provision (*lex specialis*) that governs the allocation of government shares from production sharing with contractors. The calculation method for the 85%-15% government-contractor ratio is specified in the PoD document, which is annexed to the PSC. During the term of the contract, the tax authorities of the countries where the permanent establishments were registered as tax residents concluded tax treaties with Indonesia. These treaties provided for a reduced tax rate on passive income, thereby altering the taxation rights between the two contracting states. As a result, the standard domestic Indonesian income tax rate of 20%, in place since 1983, was to be applied. However, complications emerged when these tax treaties overlapped with existing regulations during the same timeframe.

A Canadian contractor sought to apply a reduced branch profit tax rate under the Indonesia-Canada treaty but was ultimately denied by the Supreme Court.

corporate income tax, **a branch profit tax on the after-tax profit of the permanent establishment, provided that the tax so imposed shall not exceed 12,5%** of such amount."

38 Refer to the case settled through tax court decision No. Put-87275/PP/M.IIA/13/2017. The case was disputed in 2005 for fiscal year 2003. The tax court decision was released in 2017.

39 Similar arguments were also presented by the contractor for the case stipulated in Supreme Court Decision No. 1850/B/PK/PJK/2017, as the review to Tax Court Decision No. PP No. PUT-65544/PP/M.VIB/13/2015 tanggal 5 November 2015, Supreme Court Decision No. Nomor 1851/B/PK/PJK/2017 as the review to Tax Court Decision No. PUT-65547/PP/M.VIB/13/2015,

40 Id.

Conversely, a Norwegian contractor applied a 15% rate per their treaty, and while the tax authority contested this, the Supreme Court upheld the reduced rate.

Remarks to the Dispute on Branch Profit Tax – Reduction Rate

The investment was grounded in Law No. 44 Prp of 1960, tied to the Foreign Investment Law of Indonesia, which intended for foreign investors to incorporate locally, contributing significant capital and expertise. PSC contractors typically operated as permanent establishments, focusing solely on generating income within Indonesia, a legal structure that facilitated oil and gas exploitation and exploration.[41]

Tax treaties primarily address income taxation principles without dictating procedures, which defer to domestic laws. Treatments of dividends and branch profits vary by treaty, based on state agreements. Some specify non-modification of production shares in PSCs, a frequent dispute source. In theory, agreements, rooted in good faith or '*pacta sunt servanda*', should remain until mutually withdrawn or legally terminated. Good faith, essential in treaty observance, should also align with broader legal principles, serving as a benchmark for legal obligations.[42] A contract's binding nature mandates parties to honor its terms, embodying the principle of *pacta sunt servanda*. Violations may incur sanctions akin to breaches of law.[43]

Article 138(1) of Indonesia's Civil Code states that agreements legally bind those who make them. This provision ensures that contracts are seen as equal to laws made by legislators, emphasizing that the parties in a contract have the same standing. Contracts serve to translate business processes into legal language, providing a clear structure and guidelines for the parties to carry out their business activities as agreed.[44]

A PSC applied domestic law and a tax treaty is an international law; treaties can override local law. A joint venture agreement governs mining sector production

[41] Erman Rajagukguk, Hukum Investasi: Penanaman Modal Asing (PMA) dan Penanaman Modal Dalam Negeri (PMDN), Raja Grafindo Persada, (2019), p. 87.

[42] Reflection on the Principle of "Good Faith" as a Source of Normative Content for the Application and Interpretation of Double Taxation Conventions, https://www.dfdl.com/wp-content/uploads/2010/09/The_Principle_of_Good_Faith_for_the_Application_and_Interpretation_of_Double_Taxation_Conventions_BTR_2003.pdf.

[43] Subekti, Hukum Perjanjian, 2002, Jakarta: Intermasa, pp. 1-3.

[44] Hernoko Agus Yudha, 2008, Asas Proporsionalitas dalam Kontrak Komersial. Edisi 1. Yogyakarta: Laksbang Mediatama dan Koantor Advokad Hufron & Hans Simalea, pp. 2.

sharing, balancing tax distribution and legal obligations. Contractors cannot cherry-pick applicable laws; the initial law choice must stay consistent and respected, holding equal weight to actual law.

Under the prevailing income tax law, two specific provisions are addressed: Article 32A covering tax treaties and Article 33A(4) concerning PSCs, with PSCs referring to domestic law but modified by tax treaties for technical implementation. The Supreme Court, adopting judicial activism, asserts that the 85:15 net profit sharing ratio necessitates a 20% branch profit tax, achievable through renegotiation of future contracts. Existing ministry regulations, referenced in the PoD and Minister of Finance and Minister of Mines and Energy documents, may not fully support the government's stance in the contractor-government agreements. To mitigate the potential further disputes, it is crucial to incorporate a stabilization clause in forthcoming contracts to address potential future regulatory changes.

Conclusion

The PSC sets specific rules for allocating production shares and handling production costs, as affirmed by domestic tax law. Parties must honor contract terms, ensuring predictable costs for capital-intensive businesses. Contracts made in good faith should stand unless mutually withdrawn or legally terminated. The PSC specifies that contractors are bound by the tax laws effective when the contract is signed, lasting until its conclusion. This agreement includes paying taxes, such as branch profit tax, as per Indonesia's Income Tax Law at the contract's initiation, with tax obligations remaining consistent throughout the contract's life, in line with the agreed production sharing terms.

While income tax laws are dynamic and can change, reflecting global business trends and possibly leading to varied corporate tax rates, tax treaties, derived from domestic laws, provide a coordinated tax framework. Tax treaty benefits should apply to the rightful owner as per current laws. Disputes stem from divergent interpretations of withholding tax rates on branch profits between tax authorities and businesses. Reduced rates do not breach the PSC, which is based on domestic law, and the government must adhere to its international treaty commitments. In addition, to mitigate potential disputes, it is extremely essential to incorporate a stabilization clause in forthcoming contracts to address potential future regulatory changes that affect the production sharing for each party.

BIBLIOGRAPHY

Books:

Burns, Lee, and Richard Krever. "16 Taxation of Income from Business and Investment". In *Tax Law Design and Drafting, Volume 2*, (USA: International Monetary Fund, 1998) accessed May 10, 2022, https://doi.org/10.5089/9781557756336.071.ch016

Erman Rajagukguk, Hukum Investasi: Penanaman Modal Asing (PMA) dan Penanaman Modal Dalam Negeri (PMDN), Raja Grafindo Persada, 2019

Hernoko Agus Yudha, Asas Proporsionalitas dalam Kontrak Komersial. Edisi 1. Yogyakarta: Laksbang Mediatama dan Koantor Advokad Hufron & Hans Simalea, 2, 2008

Jaja Zakaria, Perlakuan Perpajakan terhadap Bentuk Usaha Tetap, (Jakarta: PT. Raja Grafindo Persada, 2007.

Kamal Hossain, Law and Policy in Petroleum Development: Changing Relations between Transnationals and Governments, London: Francis Publishers Ltd, 1979.

Rachmanto Surahmat, Persetujuan Penghindaran Pajak Berganda: Suatu Kajian terhadap Kebijakan Indonesia, Indonesia, Salemba Empat, 2011.

Rinto Pundyantoro, A to Z Bisnis Hulu Migas, Jakarta: Petromindo, 2012,

Rudi M. Simamora, Hukum Minyak dan Gas Bumi, Jakarta: Djambatan, 2000.

Nurmala Manik, Kajian Pengenaan Pajak Penghasilan atas Sektor Migas di Indonesia, Master Thesis, Department of Administrative Science, Faculty of Social and Political Science, Universitas Indonesia, 2003.

UN Model Tax Convention, retrieved from https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf.

UN Model Tax Convention Art. 10, retrieved from https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf.

Articles:

Abba Kolo, Thomas W. Wälde, 'Investor-State Disputes: The Interface Between Treat-Based International Investment Protection and Fiscal Sovereignty', 35 Intertax, Issue 8,424-449, 2007, https://kluwerlawonline.com/journalarticle/Intertax/35.8/TAXI2007049.

Arba Maulana, Penerapan Asas Proporsonalitas dalam Production Sharing Contract pada Kegiatan Usaha Pembangunan Pertambangan Hulu Migas dan Gas Bumi. Diponegoro Law Review, 5(2), 2016.

OECD, Tax Treaty Design for Resources-Rich Developing Countries. Retrieved from https://www.oecd.org/dev/Session_1_%20Tax_Treaty_Design%20for_Resource-Rich_Countries_Zero_Draft.pdf on 24 September 2021.

OECD, Are the Current Treaty Rules for Taxing Business Profit Appropriate for E-Commerce? Final Report, Centre for Tax Policy and Administration, https://www.oecd.org/tax/treaties/35869032.pdf (accessed at 17 February 2022).

Websites:

Badan Pemeriksa Keuangan, Badan Pemeriksa Keuangan Temukan Masalah Pajak Minyak dan Gas Bernilai Rp. 1,12 Triliun,(2014), retrieved from https://jdih.bpk.go.id/wp-content/uploads/2015/05/BPK-Temukan-Masalah-Pajak-Migas-Bernilai-Rp-112-Triliun.pdf.

Chandra Budi, Mengakhiri Polemik Pajak Migas, 2008, retrieved from https://www.pajak.go.id/artikel/mengakhiri-polemik-pajak-migas at 14th January 2021.

Detik Finance, Perusahaan Migas dan BPKP Beda Hitungan soal Tunggakan Pajak, 2011, retrieved from https://finance.detik.com/energi/d-1685108/perusahaan-migas-dan-bpkp-beda-hitungan-soal-tunggakan-pajak- at 14th January 2021.

Nadia Kurnia, Tiga Perusahaan Migas Tunggu SKP untuk Bayar Pajak, 2011, retrieved from https://ekonomi.bisnis.com/read/20110720/44/42922/3-perusahan-migas-tunggu-skp-untuk-bayar-pajak at 14th January 2021.

PricewaterhouseCoopers, Same Difference: Dividend and Branch Profit, 2020,retrieved from https://www.pwc.com/ph/en/taxwise-or-otherwise/2020/same-difference-dividends-and-branch-profits.html.

PriceWaterhouseCoopers, The Urgency of Building Competitiveness to Attract Oil and Gas Investment, Jakarta, 2015.

Agreement between the Government of the Republic of Indonesia and the Government of the Kingdom of the Netherlands, retrieved from https://www.pajak.go.id/id/p3b/belanda.

Regulations:

Ministry of Finance No. S-443a/MK-012/1982 dated 6 Mei 1982 with regard to Interpretation of Ministry of Finance Regulation No. 267/KMK.012/1978 regarding Procedures for Calculating and Paying Corporation Tax and Tax Against Interest, Dividend and Royalty.

Tax Court Decision

Tax Court Decision No. 096970.13/2011/PP/M.VIIIA 2019.
Tax Court Decision No. 82032/PP/M.VIIIA/13/2017.
Tax Court Decision No. 82034/PP/M.VIIIA/13/2017.
Tax Court Decision No. 110171.36/2013/PP/M.XVIA.
Tax Court Decision No. 091728.36/2010/PP/M.XIIIA.
Tax Court Decision No. 109140.36/2011/PP/MIIA.
Tax Court Decision No. 90537/PP/M.VIA/36/2017.
Tax Court Decision No. 108165.36/2013/PP/M.XIIIA.
Tax Court Decision No. 102925.36/2011/PP/M.XIIIA.

Tax Court Decision No. 80953/PP/M.XIVA/13/2017.
Tax Court Decision No. 80952/PP/M.XIVA/13/2017.
Tax Court Decision No. 109140.36/2011/ PP/M.IIA/2018.
Tax Court Decision No. 110339.36/2010/PP/M.VA/2018
Tax Court Decision No. 87275/PP/M.IIA/13/2017
Tax Court Decision No. 65544/PP/M.VIB/13/2015
Tax Court Decision No. 001917.36/2018/PP/M.IA
Tax Court Decision No. 117426.36/2011/PP/M.IA

Supreme Court Decision

Supreme Court Decision No. 368/B/PK/Pjk/2020.
Supreme Court Decision No. 435/B/PK/Pjk/2020.
Supreme Court Decision No. 716/B/PK/Pjk/2020.
Supreme Court Decision No. 750/B/PK/Pjk/2020.
Supreme Court Decision No. 751/B/PK/Pjk/2020.
Supreme Court Decision No. 1324/B/PK/Pjk/2020.
Supreme Court Decision No. 1346/B/PK/Pjk/2020.
Supreme Court Decision No. 506/B/PK/Pjk/2019.
Supreme Court Decision No. 1432/B/PK/Pjk/2019.
Supreme Court Decision No. 3338/B/PK/Pjk/2019.
Supreme Court Decision No. 3814/B/PK/Pjk/2019.
Supreme Court Decision No. 4000/B/PK/Pjk/2019.
Supreme Court Decision No. 417/B/PK/Pjk/2018.
Supreme Court Decision No. 1851/B/PK/PJK/2017.