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P U B L I C I N F O R M A T I O N

BULLETIN

NUMBER 112 SUPPLEMENT NO. 17 AUGUST 1988

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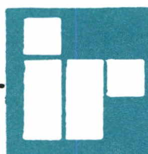

DOUBLE TAXATION CONVENTION WITH INDONESIA

THE DEPARTMENT'S TECHNICAL POLICY CIRCULARS ARE REPRODUCED IN THIS BULLETIN

FOR ADDITIONS, CORRECTIONS AND DELETIONS TO THE P.I.B. MAILING LIST PLEASE COMPLETE THE IR596 FORM AT THE BACK OF THIS BULLETIN.

Part I Introduction

The text of the Agreement has been published as a schedule to an Order in Council (SR/1988/15) and is available from Government Bookshops.

The Agreement came into force on 24 June 1988 with effect in New Zealand for any income year beginning on or after 1 April 1989.

In Indonesia it takes effect in respect of income derived during the taxable year beginning on or after 1 January 1989.

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Part II Notes on the Agreement Article by Article

Article 1 - Personal Scope

The Agreement applies to persons who are residents of New Zealand or Indonesia or both States.

Article 2 - Taxes Covered

With regard to Indonesia, the Agreement covers income tax (pajak-penghasilan).

In New Zealand, the Agreement covers income tax and excess retention tax.

Article 3 - General Definition

1. Paragraph 1 groups together various general provisions required for the interpretation of terms used in the Agreement.

"National": Paragraph 1(f)

The term "national" is used in Article 19 Government Service.

In New Zealand the term covers any individual who is a New Zealand citizen and any legal person, partnership or association deriving its status as such from the law in force in New Zealand.

In Indonesia the term covers any individual possessing the nationality of Indonesia and any legal person, partnership or association deriving its status as such from the law in force in Indonesia.

2. Paragraph 2 makes it clear that the terms "New Zealand tax" and "Indonesian tax" do not include penalties or interest imposed under the law of either state.

3. Paragraph 3 is a standard provision. Where a term is not defined it has the meaning applicable under the domestic law of the country applying the Agreement.

Article 4 - Resident

1. Paragraph 1 defines the meaning of the term "resident of a Contracting State". In effect the defined term is a reference to the domestic law of each country. Whenever the term is used in the Agreement, the residence of the taxpayer must first be determined in accordance with this Article.

2. Paragraph 2 sets out the tests to be applied to solve the problem of a dual resident individual. Dual residence arises when a taxpayer is resident in both countries by virtue of the domestic law of each country.

3. Paragraph 3 provides that where a non-individual person is resident in both countries, residence will be decided by the competent authorities having regard to the day to day management, the place of incorporation or constitution and any other relevant factors.

   In applying the tests to dual residents, as set out in paragraphs 2 and 3, it should be remembered that these tests apply only for the purposes of the Agreement. If the person resident in New Zealand (domestic law test) becomes for the purposes of the Agreement a "resident of Indonesia" after the tests have been applied, this does not mean that he is regarded as a non-resident for all purposes of New Zealand tax law. For example, he can never be subject to non-resident withholding tax, the reason being that although he is treated as a non-resident for certain purposes of the Agreement, he is still regarded as being resident in New Zealand under the Income Tax Act. However, it does mean that he is entitled to any benefits granted by the Agreement as a "resident of Indonesia". For example, although New Zealand royalty income derived by him is subject to withholding tax, he is liable for New Zealand income tax on the royalty income but qualifies for the 15 percent limitation in the Agreement.

Article 5 - Permanent Establishment

The Article defines the term "permanent establishment". This concept determines the right of a Contracting State to tax the profits of an "enterprise of the other State". Due to the inclusion of the words "includes especially" in paragraph 2, the examples cited as constituting a permanent establishment are by no means exhaustive.

The definition of "permanent establishment" is fairly standard but the following points should be noted:

Para 3(a)

a building site, a construction, assembly or installation project or supervisory activity connected to such a project, constitutes a permanent establishment if it lasts more than six months.

Para 3(b)

the furnishing of services, including consultancy services, by an enterprise through employees or other personnel where activities of that nature continue (for the same or a connected project) for a period or periods aggregating more than 3 months within any twelve month period.

PROTOCOL An enterprise shall be deemed to have a permanent establishment if it carries on for more than three months any activities in connection with the exploration or exploitation of natural resources. In this context "activities" includes the activities of supply ships and supply of labour. In applying this test where the activities of associated enterprises are connected they will be regarded as being carried on by a single enterprise.

For example, where an enterprise carries on activities for two months then transfers its activities to an associated enterprise which completes the project in say two months then both enterprises are deemed to have a permanent establishment.

Article 6 - Income from Immovable Property

This Article recognises the internationally accepted practice in relation to income from land and the exploitation of land or landed property. The Article also applies to such items as rents, natural resource royalties, farming and forestry profits, etc. The principle of the Article is that income derived by a resident of one State from immovable property situated in the other State may be taxed in the State where the immovable property is situated. "Immovable property" is not defined in our general law but the Article provides extensive definition. Ships and aircraft are excluded from the term "immovable property".

The Article involves no change in current practice in relation to the income covered, i.e., our domestic law applies.

Article 7 - Business Profits

This Article is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. Under Article 7 a Contracting State cannot tax the business profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein. If a permanent establishment exists the Article goes on to lay down a set of rules by which the profits of the permanent establishment are to be calculated.

Before dealing with the salient features of the Article some comment is warranted on the importance of paragraph 8. This is because reference to this Article and Article 5 will not always be necessary to determine the liability of the specific types of income. In effect paragraph 8 gives first preference to the other Articles in the Agreement. It follows that this Article will only be applicable to business profits which do not belong to the categories of income specifically covered in other Articles of the Agreement and, in addition, to dividends, royalties and interest which <u>specifically</u> come within the <u>circumstances</u> detailed in paragraph 4 of Articles 10 and 12, and paragraph 5 of Article 11 and consequently fall within Article 7.

1. Paragraph 1 expresses the general rule that profits are taxable only in the country of residence unless the enterprise is engaged in business in the other State through a permanent establishment, in which case the other State may tax:

   (a) the business profits of the Permanent Establishment; and

   (b) profits arising from sales made direct in the other State by the enterprise of goods or merchandise of the same or similar kind as those sold through its Permanent Establishment if made with a view to avoiding taxes in the other State.

2. Paragraph 2 contains the normal provision enabling arm's length profits to be attributed to the Permanent Establishment if necessary.

3. Paragraph 3 expresses the taxpayer's right to deduct from the profits of the permanent establishment the expenses incurred for the purposes of the permanent establishment even if those expenses are incurred outside the country where the permanent establishment is situated.

4. Paragraph 4 provides that where the profits to be attributed to a permanent establishment are determined, not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formular or certain percentage of the gross profits then such a method may continue to be employed provided it has been customary to adopt such a practice. Such a method differs from those envisaged in paragraph 2 of Article 7, since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits. However, in

general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts.

A method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and should be used only where it has, as a matter of history, been customary in the past and is accepted by the Department and taxpayer as being satisfactory.

5. Paragraph 5 precludes the attribution of profits to a permanent establishment by reason of merely purchasing activities carried on by the permanent establishment for the enterprise.

6. Paragraph 6 provides that unless there are good and sufficient reasons to the contrary the profits attributed to a permanent establishment must be determined by the same method each year.

7. Paragraph 7 provides that income from the business of any form of insurance is not subject to the provisions of this Article. Such income may be taxed in accordance with the domestic law of each country.

8. Paragraph 8: refer to initial comments above on this paragraph.

<u>Article 8 - Shipping and Air Transport</u>

1. Under this Article profits from operating ships or aircraft in "international traffic" - defined in Article 3(1)(g) are to be taxed only in the country of which the enterprise is a resident. International shipping and aircraft profits include income from:

   (a) carriage of passengers and cargo;

   (b) sale of passenger tickets on behalf of other enterprises;

   (c) commercial advertising;

   (d) charter fees (but refer paragraph 2 below).

   Due to the definition of "international traffic" exemption does not extend to profits derived from coastal traffic. Further, investment income of shipping and air transport enterprises is subject to the treatment ordinarily applied to that class of income, e.g., dividends derived would be subject to Article 10.

2. Profits obtained from leasing a ship or aircraft on charter fully equipped, manned and supplied, whether or not the enterprise providing the ship or aircraft actually owns them, would be treated as profits from the operation of a ship or aircraft. However, the Article does not extend to profits from leasing a ship or aircraft on a bare boat charter basis except when it is an occasional source of income for an enterprise engaged in the international operation of ships or aircraft. Apart form this one exception, bare boat charter fees would normally be classified as business profits and consequently dealt with under Article 7.

Article 9 - Associated Enterprises

This Article enables arm's length profits to be attributed to associated enterprises.

Article 10 - Dividends

1. Paragraph 1 simply states that dividends may be taxed in the State or residence of the recipient.

2. Paragraph 2 provides that the Contracting State from which the dividends are paid also has the right to tax, but the maximum rate of tax that can be imposed is not to exceed 15 percent of the gross amount of the dividends. Therefore, in terms of the Agreement, New Zealand's taxing rights will be restricted to 15 percent of the gross dividend even though the rate under our domestic law is 30 percent.

3. Paragraph 3 defines "dividends" for the purposes of the Article. The effect is that "dividends" has the meaning given to it by section 4 of the Income Tax Act 1976.

4. Paragraph 4 deals with dividends arising from shares which are attributable to a permanent establishment. It provides that in the State of source the dividends are taxable as part of the profits of the permanent establishment, provided they are paid in respect of holdings forming part of the assets of the permanent establishment or are otherwise attributable to that establishment. In effect this relieves the State of source of the dividends from the 15 percent limitation under the Article.

   The rules set out above also apply where the recipient of the dividends has in the other State, for the purpose of performing any of the kind of independent personal services mentioned in Article 14, a fixed base with which the holding in respect of which the dividends are paid is effectively connected.

Prior to 1 April 1982 these qualifications would have had no effect on the New Zealand tax position because our domestic law provided for a 15 percent final withholding tax in all cases on the gross payment and no Agreement can extend the taxing rights under domestic law. However, in view of the change in New Zealand domestic law from 1 April 1982 the New Zealand tax on dividends paid in respect of shares attributable to a permanent establishment will be 30 percent.

5. The main effect of paragraph 5 is that it restricts the application of taxes on undistributed profits. For example, New Zealand cannot impose excess retention tax on a privately controlled company which is a "resident of Indonesia".

Article 11 - Interest

1. Paragraph 1 affirms the taxing right of the State that the recipient of the interest is a resident.

2. Paragraph 2 also affirms the taxing right of the State in which the interest arises, but the maximum rate of tax that can be imposed is not to exceed 10 percent of the gross amount of the interest. New Zealand's tax is therefore limited to 10 percent on gross interest paid to residents of Indonesia instead of the usual 15 percent.

3. Paragraph 3 exempts from tax interest if it is paid to the Government of the other Contracting State including a political subdivision or local authority or the central bank.

4. Paragraph 4 defines "interest" for the purposes of the Article. Penalty charges are excluded from the term as is income which would, because of a State's domestic law, be classified as a dividend. Therefore, in New Zealand, for example, interest received by debenture holders under debentures to which section 192 or 195 of the Income Tax Act 1976 applies would be dealt with under the Dividend Article.

5. Paragraph 5 provides that in the State of source interest is taxable as part of the profits of the permanent establishment there owned by a resident of the other State, provided the interest is paid in respect of debt-claims forming part of the assets of the permanent establishment or otherwise attributable to that establishment. In effect this paragraph relieves the State of source of the interest from any limitation under the Article.

This qualification ties in with the New Zealand domestic law which provides that if a non-resident has a fixed establishment in New Zealand, then interest derived is not subject to non-resident withholding tax but is to be assessed on an annual basis. (See section 310 of the Income Tax Act 1976).

The rules set out above also apply where the recipient of the interest has in the other State, for the purpose of performing any of the kinds of independent personal services mentioned in Article 14, a fixed base to which the debt-claim in respect of which the interest is paid is attributable.

6. Paragraph 6 is a source rule and precludes argument as to the source of the interest.

   The paragraph deals with interest arising through a permanent establishment or fixed base. Where a loan was contracted for the requirements of that establishment and the interest is borne by that establishment, the paragraph determines that the source of the interest is in the Contracting State in which the permanent establishment is situated, leaving aside the place of residence of the owner of that establishment or base.

7. Paragraph 7 is an anti-avoidance provision to ensure that only a reasonable interest payment is taxed at the reduced rate specified in the Agreement.

Article 12 - Royalties

1. Paragraph 1 affirms the taxing right of the State in which the recipient of the royalties is a resident.

2. Paragraph 2 also affirms the taxing right of the State in which the royalties arise, but the maximum rate of tax that can be imposed is not to exceed 15 percent of the gross amount of the royalties.

3. Paragraph 3 defines "royalties" for the purposes of the Article. The term includes lump sum payments and certain rents. However, variable or fixed payments for the working of mineral deposits or other natural resources do not fall within the defined terms as they are governed by Article 6.

   It should be noted that if a payment is made in the form of rent rather than on a royalty basis and the payment comes within the term "royalties" as defined in the Agreement then the 10 percent maximum on gross applies. However, rental payments do not constitute royalties under our domestic law and there is, therefore, no non-resident withholding tax

applicable. Payments of this nature will be subject to an annual assessment on the net amount after expenses and if the tax so levied exceeds 15 percent of the gross rental, a rebate will be given by virtue of the Agreement to bring the tax down to 15 percent of gross.

4. Paragraph 4 provides that in the State of source royalties are taxable as part of the profits of the permanent establishment there owned by the recipient which is a resident of the other State, provided the royalties are attributable to that establishment. In effect this relieves the State of source of the royalties from the 15 percent limitation under the Article.

   The rules set out above also apply where the recipient of the royalties has in the other State, for the purpose of performing independent personal services, a fixed base to which royalties are attributable.

   New Zealand's domestic law in relation to royalties provides for a withholding tax rate of 15 percent final on copyright (cultural) royalties or where the aggregate annual royalty payments do not exceed $1,000, while a maximum final tax applies in all other cases.

5. Paragraphs 5 and 6 - the comments to paragraph 6 and 7 of the Interest Article apply equally here.

Article 13 - Alienation of property

1. Paragraph 1 concerns income or gains derived from the alienation of immovable property. Income or gains from such alienation may be taxed in the State where the property is situated. For example, if a resident of Indonesia sells at a profit immovable property situated in New Zealand the profit can be taxed in New Zealand if the New Zealand domestic law permits that taxation.

2. Paragraph 2 deals with income or gains from the alienation of personal property forming part of the business property of a permanent establishment or pertaining to a fixed base used for performing independent personal services. Such gains may be taxed in the State where the permanent establishment of fixed base is situated.

3. Paragraph 3 provides that income or gains from the alienation of ships or aircraft operated in international traffic are taxable solely in the State of residence of the enterprise.

4. Paragraph 4 stipulates that any income or gains from any property not covered by the Article is to be taxable solely in the State of which the alienator is a resident.

Article 14 - Independent personal services

1. This Article concerns income from personal services (i.e., independent personal services) as distinct from income from dependent personal services (e.g., remuneration such as salary or wages) which is dealt with separately under Article 15. Income from independent personal services is taxable only in the State of residence unless the services are performed in the other State and the recipient of the income:

   - is present in the other State for a period or periods amounting to or exceeding in the aggregate 90 days in any consecutive twelve month period; or

   - has a fixed based regularly available to him in the other State for the purpose of performing his activities.

   If either of the above exceptions applies the State in which the services are performed also has the right to tax the income therefrom.

   The term "fixed base" is intended to cover a centre of activity of a fixed or permanent character, for instance a doctor's consulting room or the office of an architect or lawyer.

2. The Article does not apply to artistes or athletes, who are dealt with under Article 17.

Article 15 - Dependent personal services

1. Paragraph 1 states the general rule that personal services performed by a resident of one of the Contracting States may be taxed in the other Contracting State, only if the services are performed in that other State.

2. Paragraph 2 states the case where exemption will be given by the State visited. The main requirements are that:

   - the recipient of the income is present in the State visited for a period or periods which do not exceed in the aggregate 183 days in any consecutive twelve month period; and

   - the remuneration is paid by an employer not resident in that State; and

   - the remuneration is not connected with the activities of a permanent establishment or fixed base which the employer has in that State.

Regarding the 183 day test the term "consecutive twelve month period" should be noted as the treatment effectively differs from the term "income year" which is used in other treaties.

Where the term "income year" is used for the purposes of the 183 days test each income year is looked at separately in determining the number of days present. Therefore the exemption could apply where a visit of more than 183 days straddles two income years provided the visit does not exceed 183 days in either year.

When applying the "consecutive twelve month period" criterion it should be remembered that each day means the commencement of a period of 12 months from that particular day. Thus, although a visit may straddle two income years the exemption will not apply if the visit exceeds 183 days over a period of 12 months. For example, an Indonesian resident who visits New Zealand on 1 November and departs on the following 30 June will not be exempt as he will have been present in New Zealand for more than 183 days in a consecutive 12 month period.

In this example, if the criterion was an "income year" instead of "consecutive 12 month period" the visitor would be exempt as at no stage would he be present in New Zealand for more than 183 days in an income year.

When a visitor from Indonesia undertakes employment in New Zealand, New Zealand PAYE tax will be required to be deducted from the remuneration paid but will be refunded at the time of departure provided the requirements of the Article are fully met. In this respect a certificate must be obtained, by the person seeking exemption, from the Indonesian authorities which certifies that that person is resident in Indonesia for the purposes of Indonesian tax.

3. Paragraph 3 provides that remuneration derived from employment aboard a ship or aircraft operating in international traffic may be taxed in the State of residence of the shipping or airline enterprise. This means that if the enterprise is a resident of Indonesia then Indonesia has the right to tax the remuneration derived by the employee.

Article 16 - Directors' Fees

This Article allows the State of residence of the company paying the fees or other similar payments to have the right to tax such income. The income may also be taxed in the recipient's country or residence which would therefore have to allow credit for tax paid in the country of source.

Article 17 - Artistes and Athletes

1. Paragraph 1 enables the State in which the entertainer or athlete is performing the services to tax the income derived from these personal activities.

2. Paragraph 2 deals with the situation where income for the performance of an entertainer or athlete is not paid or paid in full to the entertainer or athlete himself but to an enterprise providing the services of the entertainer or athlete. The paragraph permits the State in which the performance is given to impose a tax on the profits diverted from the income of the entertainer or athlete to the enterprise where, for instance, the entertainer or athlete has control over or rights to the income thus diverted or has obtained or will obtain some benefit directly from that income. Without this paragraph the State where the services are being performed would, in such cases, be unable to tax:

   (a) because it would not be personal service income to the entertainer; and

   (b) in the absence of a permanent establishment the payments could not be taxed as business profits in the hands of the other person.

3. The effect of Paragraph 3 is that the State in which the activities are performed will not tax the income derived if the entertainer or athlete is performing under a cultural agreement or arrangement supported by funds of the Government of the other Contracting State, a local authority or public institution thereof.

Article 18 - Pensions and Annuities

1. Paragraph 1 gives the state of residence exclusive rights to tax pensions where they are paid in consideration of past employment. However, this rule is subject to Article 19(2) wherein Government pensions paid in respect of services rendered are taxed exclusively in the State of source but if the recipient is a resident and a national of the other State the pensions are taxable on a residence basis. (See definition of "national" in Article 3). This means that an Indonesian Government pension paid to a resident of New Zealand is taxed only in Indonesia and exempt in New Zealand unless the recipient is also a national of New Zealand in which case the pension is taxed only in New Zealand and exempt in Indonesia.

2. Paragraph 2 provides that social security pensions may be taxed in the State paying the pension, i.e., State of source.

3. Paragraph 3 defines "pensions' and "annuities".

Article 19 - Government Service

1. This Article deals with remuneration paid to an individual in respect of services rendered to a State or political subdivision or local authority thereof.

2. Paragraph 1 provides for two situations:

- Remuneration paid by a State in respect of services rendered to it by an individual shall be taxable only in that State.

- However, such remuneration shall be taxed exclusively in the other State if the services are rendered in that State by an individual who is a resident of that State, and who is also a national of that State and did not become a resident of that State solely for the purposes of rendering those services.

The second situation can be illustrated as follows.

Remuneration paid by the Indonesian Government for service rendered in New Zealand by an individual who is a resident and national of New Zealand shall be taxed exclusively in New Zealand.

This is still the position even though the individual, although a national of New Zealand, did become a resident of New Zealand for the purposes of rendering those services for the Indonesian Government.

3. Paragraphs 1 and 2 do not apply if the services are performed in connection with business carried on by the State, or one of its political subdivisions or local authorities, paying the remuneration. In that event under paragraph 3 the ordinary rules apply: Article 15 for wages and salaries, Article 16 for Directors' fees, Article 17 for Artistes and Athletes and Article 18 for Pensions and Annuities.

Article 20 - Professors and Teachers

1. Under Paragraph 1 an Indonesian professor or teacher is exempt from New Zealand tax on his income from carrying out teaching or research in New Zealand if:

- at the invitation of a university, college, school or other similar education institution he visits New Zealand for not more than two years;

- he is or was a resident of Indonesia immediately before visiting New Zealand;
- his visit is solely for the purpose of teaching or research.

The same rules apply conversely to a resident of New Zealand visiting Indonesia for the same purpose.

Before granting exemption evidence is required in the form of a statement from the taxation authority that he will be subject to tax in his own country.

2. Paragraph 2 sets out the condition that for paragraph 1 to apply the research must be undertaken in the public interest and not for the private benefit of a specific person or persons.

Article 21 - Students

This Article exempts from New Zealand tax, maintenance, education or training payments received here from overseas by a student or business apprentice from Indonesia. Note:

- The student or apprentice must have been a resident of Indonesia immediately before he comes to New Zealand.
- He must be in New Zealand solely for the purpose of his education or training.
- There is no time limit on the period spent in New Zealand.
- The exemption is restricted to the payments mentioned, i.e., for maintenance.

The converse applies to a New Zealand student or apprentice going to Indonesia.

Article 22 - Other Income

1. This Article provides a general rule relating to income not dealt with in other Articles of the Agreement. The income concerned is not only income of a class not expressly mentioned. The effect of the Article is that income derived by a resident of New Zealand is taxed exclusively in New Zealand unless the income is derived from sources in Indonesia. If the income is derived from sources in Indonesia it may also be taxed there and a credit for the Indonesian tax is given in New Zealand should that income be liable for New Zealand tax. The converse will apply in the case of a resident of Indonesia. Cases of conflict between two residents are to be determined by reference to Article 4.

2. A secondary effect of the Article is to clarify the situation of income derived from a third country by a person who could be "resident in" both Indonesia and New Zealand under the general laws of each country. Under the Agreement that person can be a "resident of" only one country. In such a situation the taxing rights are allocated to the country "of" which he is a resident.

Article 23 - Methods of Elimination of Double Taxation

1. This article contains the normal rules whereby each State gives credit for the other State's tax when assessing its residents on income derived from sources in the other State. It should be noted that the credit provisions in the Article are subject to the domestic law of each country.

2. Paragraph 3 is a source rule for the purposes of the Article in order to solve any dual source cases whcih may arise thus facilitating the allowance of a credit.

Article 24 - Mutual Agreement Procedure

Article 25 - Exchange of Information

These are standard Articles and require no further comment.

Article 26 - Diplomatic and Consular Officer

The aim of the article is to ensure that diplomatic agents or consular officers shall, under the Agreement, receive no less favourable treatment than that to which they are entitled under international law or under special international agreements.

Article 28 - Entry Into Force

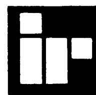
This Article provides that the Agreement will take effect in New Zealand for any income year beginning on or after 1 April 1989 and in Indonesia for any taxable year beginning on or after 1 January 1989.

Article 29 - Termination

This Article sets out the procedure if either State wishes to terminate the Agreement. Unless notice of termination is given in accordance with the Article the Agreement continues indefinitely.

Protocol

The Protocol deals with Article 5 "Permanent Establishment". The main points are explained earlier in this suppliment under Artlicle 5.



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