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A JURIDICAL REVIEW OF THE ESTABLISHMENT OF SIGNIFICANT ECONOMIC PRESENCE AS A SUBSTITUTE FOR THE TRADITIONAL PERMANENT ESTABLISHMENT (PE) IN THE COLLECTION OF INCOME TAX FROM FOREIGN DIGITAL COMPANIES

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Abstract

The acceleration of the digital economy has catalyzed cross-border business models that allow foreign digital enterprises to generate massive profits from domestic markets without any physical presence (scale without mass). This condition leads to the erosion of the tax base for market jurisdictions like Indonesia. This article normatively analyzes the transformation of tax law doctrines from the traditional Permanent Establishment (PE) concept based on physical nexus to the criteria of Significant Economic Presence (SEP). This research employs a normative legal research method with a statutory approach and a conceptual approach. The results indicate that the enactment of SEP in the Law on Harmonization of Tax Regulations (UU HPP) is a legitimate manifestation of fiscal sovereignty to reflect the modern economic value creation theory. However, its unilateral enforcement conflicts with international law, specifically Articles 26 and 27 of the 1969 Vienna Convention on the Law of Treaties (VCLT), as long as bilateral Tax Treaties have not been modified. As a pragmatic measure, Indonesia has deferred the execution of SEP-based Income Tax and shifted towards optimizing Digital VAT (PPN PMSE) to avoid global economic retaliation, such as Section 301 of the US Trade Act.

Keywords: Permanent Establishment, Significant Economic Presence, Digital Tax, Vienna Convention 1969

INTRODUCTION

Advances in information technology over the past few decades have brought about fundamental changes in government administration in various countries, including Indonesia. Digitalization has become a key tool for improving the efficiency, transparency, and accountability of public services. One sector that has undergone significant transformation is the tax sector, where the government, through the Directorate General of Taxes (DJP), has developed a technology-based tax administration system known as the Coretax Administration System (Coretax). The era of digital technology growth has given rise to a phenomenon of globalization driven by the Fourth Industrial Revolution, fundamentally transforming the global commercial landscape. Multinational companies in the digital sector are now able to conduct large-scale business operations in a country without establishing any physical infrastructure in the target market. The characteristics of the digital economy, commonly described as scale without mass and its heavy reliance on intangible assets, have created a truly borderless trading environment. The freedom to conduct transactions without territorial limitations has prompted policymakers to reconsider the boundaries of tax sovereignty.

Indonesia, with its large productive population and high level of consumer spending, has become an attractive market for these digital businesses. For a developing country with a vast digital consumer base such as Indonesia, this phenomenon is a double-edged sword. On the one hand, digitalization promotes economic efficiency; on the other hand, it creates significant leakage of potential state revenue from Income Tax (PPh). Global technology giants are able to generate trillions of Rupiah from data traffic, digital advertising, and domestic e-commerce transactions, while shifting their profits to low-tax jurisdictions (tax haven countries). This has become a major concern for Indonesia's tax authorities, as the government seeks to increase tax revenue from this sector. The fiscal need to finance national development requires a progressive reform of tax law in relation to cyberspace. Regulations were introduced to address this need. However, the ambition to increase tax revenue should have been supported by complementary regulations and should not have conflicted with international agreements. In practice, the regulations introduced directly challenged one of the fundamental pillars of international tax law established during the era of the League of Nations in the 1920s, namely the traditional Permanent Establishment (PE) doctrine. For more than a century, the right to tax the business profits of foreign enterprises has been based on the principle of physical presence. A market jurisdiction has the authority to tax the profits of a foreign company only if the company maintains a branch office, warehouse, factory, or other physical presence within its territory. This physical presence requirement continues to serve as the basis for exercising taxing rights over income under the source principle.

As digital technology rapidly expanded and cyberspace diminished the importance of physical presence, the traditional Permanent Establishment doctrine experienced a serious crisis of relevance. A conflict emerged between legal doctrine and economic reality: the digital economy operates seamlessly, with capital moving across borders within milliseconds, while traditional international tax law continues to rely on rigid geographical boundaries. To overcome this impasse, a new legal concept known as Significant Economic Presence (SEP) was introduced. SEP shifts the basis of fiscal jurisdiction from physical nexus to substantial digital economic interaction (economic nexus). The primary legal basis for the SEP concept in Indonesia is Law Number 7 of 2021 concerning the Harmonization of Tax Regulations (HPP Law), specifically Article 2 paragraph (5) of the Income Tax Law. This provision authorizes the Government to classify foreign taxpayers (foreign digital companies) as Permanent Establishments (PE) even in the absence of a physical office or physical presence in Indonesia, provided that they have a significant economic presence in the country. Although the law establishes the SEP concept, its technical implementation requires further regulation. Consequently, Government Regulation Number 9 of 2021 was enacted as a supporting regulation, providing the legal basis for the tax authority to appoint other parties, such as digital platforms, as tax collectors, although its primary focus remains on Value Added Tax (VAT) for Electronic Commerce (PMSE). This article examines the legal transformation of the Permanent Establishment doctrine and the dynamics of its implementation within both Indonesia's domestic tax system and the international tax framework.

LITERATURE REVIEW

The principle of territorial sovereignty, which serves as the foundation of state sovereignty, is a fundamental concept in international law that grants a state the highest authority to govern its domestic affairs without foreign interference. In the economic sphere, this sovereignty is reflected in fiscal sovereignty, namely the exclusive right of a state to impose taxes on subjects and objects within its territorial jurisdiction in order to finance governmental functions. In conventional international tax law, fiscal sovereignty is justified by two main principles derived from the Theory of Economic Allegiance, formulated by the League of Nations in 1923. The Residence Principle provides that a state has the right to tax the worldwide income earned by taxpayers who reside within its territory. On the other hand, the Source Principle grants a state the right to tax income derived from sources within its geographical territory, regardless of where the taxpayer resides.

To reconcile overlapping tax claims between the residence state and the source state, international law developed the doctrine of the traditional Permanent Establishment (PE). The PE doctrine functions as a legal threshold. Under Article 5 of the OECD Model, the source state may tax the business profits of a foreign enterprise only if there is a genuine physical presence (physical nexus) in the market jurisdiction, such as a branch office, factory, warehouse, or the presence of a dependent agent for a specified period. Such physical presence is regarded as evidence that the foreign enterprise has benefited from the public infrastructure of the source state and has established an economic connection with that jurisdiction. The digital business model has created an anomaly that undermines the relevance of the physical nexus requirement. Transnational digital corporations now operate under the principle of scale without mass, generating profits remotely through algorithms, automation, and cloud computing. To restore fiscal fairness disrupted by this dematerialization, global tax law has adopted the Value Creation Theory. Popularized through the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, this theory holds that taxing rights over business profits should be allocated to the jurisdiction where the real economic activities that generate value take place. In the digital environment, value creation is no longer determined solely by capital and physical labor in the residence state, but has shifted significantly to the market jurisdiction through three intrinsic elements. First, network effects, whereby the commercial value of digital platforms, such as social media and search engines, increases exponentially as the number of users in the market country grows. Second, user-generated content and data, where domestic users act as producers of valuable raw data by voluntarily providing information through digital interactions. Third, local monetization, in which the collected data is processed through centralized algorithms and converted into profits through digital advertising specifically targeted at domestic consumers.

Based on the Value Creation Theory, the concept of Significant Economic Presence (SEP) was developed as a legal fiction. SEP reconstructs the traditional physical PE concept by introducing the criterion of economic nexus, under which the fiscal sovereignty of the source state is established based on measurable digital indicators, such as the volume of digital transactions, the size of the local user base, and structured digital commercial interactions, even when the foreign corporation has no physical presence within the territory of the market state. The unilateral implementation of the SEP concept by a country often gives rise to conflicts with existing international treaties. To analyze the legal standing of SEP in relation to international agreements, the Theory of the Relationship between International Law and National Law is applied, which consists of two major schools of thought. The Monist School views international law and national law as forming a single unified legal system. Under the Monist approach with the primacy of international law, international law prevails over domestic law, meaning that domestic legislation is automatically invalid if it conflicts with an international treaty. In contrast, the Dualist School considers international law and national law as two separate, independent legal systems derived from different sources of sovereignty. Under this approach, an international legal instrument, such as a Double Taxation Agreement (DTA), becomes binding domestically only after it has been formally incorporated into national law through an act of transformation.

Furthermore, the 1969 Vienna Convention on the Law of Treaties (VCLT) governs the law of international treaties. It contains two fundamental principles that are binding upon its parties. The first is the principle of Pacta Sunt Servanda (Article 26 VCLT): Every treaty in force is binding upon the parties to it and must be performed by them in good faith. Accordingly, states are obligated to comply with bilateral tax treaties that restrict taxing rights in the absence of a physical Permanent Establishment. The second is the Supremacy of Treaties (Article 27 VCLT): A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. Consequently, a state may not rely on newly enacted domestic tax legislation, such as SEP provisions, to justify non-compliance with its obligations under a tax treaty. Therefore, under the doctrine of Lex Specialis Derogat Legi Generali, a Double Taxation Agreement (DTA) functions as a special legal instrument that limits or overrides the application of general domestic law (treaty overriding). This theoretical framework confirms that the legal validity of the unilateral implementation of SEP by a market jurisdiction will continue to face legal constraints under the obligations imposed by the 1969 VCLT, unless the Permanent Establishment provisions in the applicable tax treaties are formally amended through a multilateral agreement.

METHOD

This study employs normative legal research (doctrinal legal research), which examines law from an internal perspective by focusing on written legal norms as its object of analysis. The research applies a Statutory Approach to examine Law Number 7 of 2021 on the Harmonization of Tax Regulations and relevant international conventions, as well as a Conceptual Approach to analyze the shift from the Permanent Establishment (PE) doctrine to Significant Economic Presence (SEP) and the underlying principles of international taxation. Secondary data were obtained from primary legal materials (legislation and international conventions), secondary legal materials (legal journals, books, and OECD drafts), and tertiary legal materials (legal dictionaries). The data were analyzed using a qualitative normative method through systematic and teleological interpretation to produce precise conclusions.

RESULTS AND DISCUSSION

The deconstruction of the traditional Permanent Establishment (PE) doctrine is rooted in the Theory of Economic Allegiance, developed by Georg von Schanz in the late nineteenth century. This theory holds that taxing rights should be allocated to the country with the strongest economic connection. At that time, the strongest economic connection could only be demonstrated through a visible physical presence. This principle was later codified in Article 5 of the OECD Model and the UN Model concerning the definition of a Permanent Establishment (PE). As the economy became increasingly digitalized, the process of value creation shifted dramatically. The profits of digital enterprises no longer originate from physical means of production, but rather from network effects, the active participation of domestic users who voluntarily provide their personal data, data monetization, whereby sophisticated algorithms process user data into targeted advertising opportunities, and user contribution, in which content uploaded by local users becomes the primary commodity of digital platforms. In response to this shift, the concept of Significant Economic Presence (SEP) emerged as a new legal fiction designed to overcome the rigidity of the traditional physical PE doctrine. The essence of SEP is that, although a foreign digital corporation may have no physical presence within a market jurisdiction, it is legally deemed to be present if it satisfies certain quantitative and qualitative indicators, such as the amount of gross revenue generated from that country, the number of active users, or the volume of digital contracts. SEP therefore shifts the basis of taxing jurisdiction from physical territorial boundaries to virtual economic jurisdiction. The legal construction of SEP within Indonesia's domestic legal system and its conflict with the 1969 Vienna Convention on the Law of Treaties (VCLT) can be seen in its underlying principles. The Indonesian Government progressively adopted the SEP concept into domestic law through Government Regulation in Lieu of Law (Perpu) Number 1 of 2020, which was subsequently enacted into law and reaffirmed in Article 2 paragraph (5) of Law Number 7 of 2021 on the Harmonization of Tax Regulations (HPP Law). Under this legislation, foreign taxpayers with a significant economic presence in Indonesia may be classified as Permanent Establishments (PE) and become subject to Indonesian Corporate Income Tax. However, this is precisely where the legal conflict arises. Tax law does not operate in isolation; it is constrained by the network of Double Taxation Agreements (DTAs), or Tax Treaties, that Indonesia has concluded with more than seventy treaty partners. Most of these treaties continue to adopt the traditional PE definition, which requires physical presence. Consequently, when Indonesia seeks to enforce its domestic SEP provisions against digital companies resident in treaty partner countries, such as the United States, enforcement immediately encounters the limitations imposed by the 1969 Vienna Convention on the Law of Treaties (VCLT).

Two provisions of the VCLT serve as the principal safeguards of international treaty obligations. Article 26 (Pacta Sunt Servanda) provides that every treaty in force is binding upon the parties and must be performed in good faith. Accordingly, Indonesia's attempt to tax foreign enterprises without a physical Permanent Establishment may be viewed as inconsistent with its commitments under existing tax treaties. In addition, Article 27 (Internal Law and Observance of Treaties) stipulates that a state may not invoke its domestic law in this case, the HPP Law as justification for failing to fulfill its obligations under an international treaty. Therefore, from the perspective of international legal hierarchy, the SEP provisions contained in the HPP Law are non-enforceable against taxpayers protected by an effective Double Taxation Agreement, unless the relevant treaty is first amended through bilateral negotiations or through a multilateral instrument such as the Multilateral Instrument (MLI).

The legal limitations imposed by the 1969 Vienna Convention are further compounded by geopolitical pressure from the residence countries of major technology companies. The United States, through the Office of the United States Trade Representative (USTR), actively relies on its domestic legal instrument, Section 301 of the U.S. Trade Act of 1974. The USTR has initiated Section 301 investigations against countries that impose unilateral digital taxes and has monitored regulatory developments in Indonesia. The United States considers income taxation based on SEP or the Electronic Transaction Tax (ETT) to be discriminatory measures that specifically target the economic interests of American technology companies. Should Indonesia proceed with the implementation of SEP-based income taxation, the United States has threatened to impose retaliatory measures, including additional import tariffs of up to 25 percent on Indonesia's leading non-digital export products entering the U.S. market.

Faced with a legal deadlock arising from the need to increase state revenue, the constraints of the Vienna Convention, and the risk of a trade dispute under Section 301, the Indonesian Government has adopted a strategy of pragmatic compliance. This strategy has been implemented through two practical measures. First, Indonesia has adopted a standstill approach regarding SEP-based income taxation by postponing its implementation. The Government has refrained from issuing a Minister of Finance Regulation establishing the technical provisions and tax rates for SEP-based income tax while awaiting the outcome of the OECD/G20 Pillar One Multilateral Consensus, which is expected to fundamentally reform the global Permanent Establishment framework. Second, Indonesia has shifted its focus toward Value Added Tax on Electronic Commerce (VAT on PMSE) as an alternative source of revenue. This approach is legally secure because VAT is governed by the destination principle, under which tax is imposed on consumption within the taxing jurisdiction, and is not regulated or restricted by Double Taxation Agreements. Since VAT is levied on the consumption of Indonesian residents while foreign digital platforms merely act as tax collectors (withholding agents), this policy avoids conflict with Article 27 of the Vienna Convention and reduces the risk of retaliatory measures under Section 301 of the U.S. Trade Act.

To address the complexity of cross-border digital tax disputes, a comparative analytical framework is required to distinguish the fundamental principles, jurisdictional bases, and economic interests underlying the five legal instruments that intersect in cyberspace. This conflict is not merely a matter of differing tax rules or rates, but reflects a broader struggle between unilateral domestic sovereignty, multilateral treaty commitments, coercive economic hegemony, and supranational regional integration

Table 1. Comparative Matrix of the Characteristics and Legal Principles of Global Digital Tax Regulations

Dimension of Analysis	**Domestic SEP Regulation (e.g., Indonesia's HPP Law)**	**P3B / Tax Treaty Bilateral**	**1969 Vienna Convention on the Law of Treaties (VCLT)**	**Section 301 US Trade Act 1974**	**European Union (EU) Regulations / Directives**
Legal Nature	Unilateral – Domestic	Bilateral – International	Multilateral – Supranational (Treaty on Treaties)	Unilateral – Domestic (U.S. Protectionism)	Regional – Supranational (Binding on Member States)
Nexus	*Economic Nexus (Digital revenue, active users)*	*Physical Nexus (Branch office, physical warehouse)*	Procedural (Validity, interpretation, and ratification of treaties)	Geopolitical (Protection of U.S. corporate economic interests)	Campuran (*Market-base* & integrasi Mixed (Market-based approach and regional system integration)regional).
Primary Principle	*Value Creation (Taxation where economic value is created)*	*Source and Residence Distinction (Prevention of conventional double taxation)*	*Pacta Sunt Servanda (Article 26) and Treaty Supremacy (Article 27)*	Economic Retaliation (Imposition of coercive import tariffs)	*Single Market Harmonization and Sectoral Transparency*
Targeted Subjects	Foreign digital corporations (MNEs) without physical presence	Conventional resident and non-resident taxpayers	Sovereign states that are parties to the Convention	Foreign states whose policies are considered discriminatory toward the United States	Large global digital corporations (Gatekeepers)
Operational Impact	*Non-enforceable when conflicting with an effective DTA*	Restricts the source state's taxing rights in the absence of a physical Permanent Establishment	Prevents states from engaging in treaty override	May trigger trade wars through retaliatory export tariffs	Requires uniform implementation across the regional bloc

The conceptual conflict between domestic SEP unilateralism and the multilateral framework of the 1969 Vienna Convention reflects the tension between static fiscal needs and dynamic international legal certainty. The fundamental nature of SEP lies in a unilateral action taken by the market jurisdiction, driven by the modern Value Creation doctrine. In contrast, the 1969 Vienna Convention on the Law of Treaties (VCLT) serves as the guardian of international legal stability through Article 26 (Pacta Sunt Servanda) and Article 27. The VCLT upholds the principle that bilateral commitments under Double Taxation Agreements (DTAs) should not be undermined by domestic fiscal ambitions. As a result, a legal gap emerges: from a socio-economic perspective, SEP represents a fair approach to taxation, yet from a formal legal perspective, its implementation is procedurally inconsistent with international law unless the relevant tax treaties have first been amended. From the perspective of the coercive hegemony of Section 301 of the U.S. Trade Act versus the fiscal sovereignty of developing countries, Section 301 introduces a legal paradigm grounded entirely in economic realism. Rather than pursuing substantive tax justice, this instrument employs the strength of the U.S. domestic market as a form of political leverage. When market jurisdictions such as Indonesia adopt SEP, the United States, through the Office of the United States Trade Representative (USTR), does not challenge the policy before an international court. Instead, it shifts the dispute into the sphere of international trade law by imposing retaliatory tariffs. The underlying principle of Section 301 directly challenges the concept of fiscal sovereignty by asserting that U.S. digital corporations should not be subjected to unilateral taxation, even when those corporations derive substantial economic benefits from the data and economic activities of consumers in the market jurisdiction. This represents a conflict between positive law in the market country and economic power politics. A critical point of analysis is that Section 301 has been able to influence the development of international tax policy not because its legal arguments are necessarily stronger, but because the economic consequences of its retaliatory measures are perceived as more severe than any formal legal sanctions.

From the perspective of European Union regional regulation, the EU presents a middle path that challenges the pace of the global consensus. Compared with Indonesia's SEP framework, the European Union, through initiatives such as the proposed Digital Services Tax and the early implementation of the Pillar Two Global Minimum Tax, has sought to move beyond the slow progress of the OECD/G20 negotiations. Unlike Indonesia, which acts independently, the EU acts collectively as a single economic bloc. The guiding principle of the EU is the protection of the Single Market. The EU recognizes that if individual Member States, such as France, Italy, and Spain, were to introduce separate SEP-based rules, the result would be regulatory fragmentation that could undermine European integration. Consequently, the EU has intervened by establishing harmonized regional regulations. Nevertheless, this regional approach creates conflicts on two levels. Vertically, it appears to challenge the OECD principle discouraging the ring-fencing of the digital economy. Horizontally, it has become a primary target of Section 301 investigations by the United States, given that the principal targets of the Digital Markets Act and European digital tax initiatives are predominantly technology companies based in Silicon Valley.

CONCLUSION

The establishment of Significant Economic Presence (SEP) represents a legal effort to reconstruct the traditional Permanent Establishment (PE) doctrine, which is no longer compatible with the borderless nature of cyberspace. SEP seeks to promote fiscal fairness by recognizing that value creation in the digital economy is driven by the contribution of domestic users rather than by the existence of physical premises. However, for states that are parties to the 1969 Vienna Convention on the Law of Treaties (VCLT), such as Indonesia, this gives rise to international contractual obligations that limit the exercise of domestic fiscal sovereignty. Under Articles 26 and 27 of the VCLT, Indonesia cannot unilaterally enforce SEP-based Income Tax without breaching its existing Double Taxation Agreements (DTAs). This legal tension is further intensified by the threat of economic retaliation under Section 301 of the U.S. Trade Act. Ultimately, Indonesia's decision to postpone the implementation of SEP-based Income Tax in order to comply with international law, while compensating for potential revenue through the optimization of VAT on Electronic Commerce (VAT on PMSE), reflects a pragmatic legal compromise aimed at preserving national economic stability amid the fragmented landscape of global digital taxation.

For Indonesia, this comparative analysis demonstrates that domestic law remains highly vulnerable when operating independently within the borderless environment of cyberspace. Indonesia does not possess the regional political and economic influence enjoyed by the European Union to withstand retaliatory measures under Section 301, while at the same time remaining bound by its obligations under Article 27 of the 1969 Vienna Convention. Accordingly, the decision to suspend the implementation of SEP-based Income Tax and instead focus on VAT on PMSE should not be viewed merely as an administrative policy of the Directorate General of Taxes, but rather as the most rational geopolitical legal decision to safeguard the national economy from the risks associated with multilateral trade disputes.

This normative legal research reaches two fundamental conclusions regarding the existence and applicability of the Significant Economic Presence (SEP) concept in Indonesia. First, SEP possesses domestic legitimacy but remains ineffective at the international level. The expansion of the Permanent Establishment definition through the introduction of the Significant Economic Presence criterion under Article 2 paragraph (5) of the Income Tax Law, as amended by the HPP Law, has a strong philosophical and sociological foundation for strengthening Indonesia's fiscal sovereignty in the digital economy. Nevertheless, from a formal legal perspective, its unilateral implementation conflicts with Articles 26 and 27 of the 1969 Vienna Convention on the Law of Treaties. As long as Indonesia's bilateral Double Taxation Agreements, which continue to require a physical nexus, remain unchanged, the principle against treaty override renders domestic SEP-based Income Tax provisions non-enforceable.

Second, the rationality of policy within the context of geopolitical dynamics. The comparative analysis demonstrates that unilateral digital taxation is consistently exposed to the risk of aggressive economic retaliation, including the imposition of punitive import tariffs under Section 301 of the U.S. Trade Act of 1974. Unlike the European Union, which benefits from substantial regional economic bargaining power, Indonesia remains particularly vulnerable to the consequences of a trade dispute. Therefore, the Indonesian Government's decision to adopt a standstill policy by postponing the implementation of SEP-based Income Tax while maximizing the collection of VAT on PMSE represents the most rational, legally sound, and economically beneficial fiscal policy for maintaining national economic stability.

To provide practical recommendations for the future development of Indonesia's international tax policy, several proposals are advanced. First, accelerating multilateral tax diplomacy under OECD Pillar One. The Indonesian Government, through the Directorate General of Taxes, should remain actively engaged in supporting the ratification of the OECD/G20 Pillar One Multilateral Convention (MLC). Collective ratification constitutes the only internationally legitimate legal mechanism for transforming Indonesia's domestic SEP concept into a globally recognized standard without violating the 1969 Vienna Convention or provoking retaliatory measures from the residence countries of major digital enterprises.

Second, optimizing the use of PMSE VAT data for regulatory oversight. During the standstill period for SEP-based Income Tax, the Government should utilize the existing VAT on PMSE collection system to accurately map transaction volumes, active user bases, and the actual gross revenues generated by foreign digital corporations in each jurisdiction. This approach is essential to establish a robust data analytics framework in preparation for the future implementation of an internationally agreed consensus.

Third, formulating a robust roll-back clause. In drafting future implementing regulations, particularly Minister of Finance Regulations, policymakers should incorporate a clear transition or roll-back clause. Such a provision would ensure that Indonesia's domestic regulations automatically align with the final provisions of the OECD/G20 Pillar One Multilateral Convention, thereby minimizing legal uncertainty and preventing future disputes arising from conflicting interpretations before the tax courts.

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