

# Reconstruction Concept of the Meaning of Permanent Establishment Physical Presence for Tax Purposes

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**ABSTRACT:** Technological developments have fostered cross-border e-Commerce transactions. This study aims to reconstruct the concept of the meaning of physical presence in the criteria for identifying foreign individuals and foreign entities as permanent establishments. Reconstruction uses the terminology of physical presence, which is adjusted to the presence of a new post-pandemic order, namely maintaining distance in certain situations. The term maintaining distance is translated as the distance between foreign individuals, foreign entities, and service users. This study proposes a reconstruction of the concepts of physical presence, the subject of permanent establishments, and the objects of permanent establishments. The concept of Significant Economic Presence is relevant to the fulfillment of three criteria: revenue, digital, and user. The reconstruction of permanent establishments involves determining the digital and user aspects. Reconstruction of permanent establishments involves determining the digital aspect of income. This study proves the hypothesis that the addition of Significant Economic Presence criteria to the determination of permanent establishments in e-commerce transactions increases the fairness of taxation rights in the source country. Therefore, it is necessary to review the determination of permanent establishments, especially e-commerce transactions, which are not limited to a physical presence with a wider scope through revenue, digital, and user criteria. This study makes a theoretical contribution to the significance of economic presence by replacing the meaning of the physical presence of a permanent establishment. Thus, the potential for permanent establishment taxation is not limited to the potential value-added tax but can also be on the potential income tax.

**KEYWORDS:** Permanent Establishment, Physical Presence, Reconstruction, Significant Economic Presence, Fairness, Tax Reform, Tax Treaty.

## INTRODUCTION

After the pandemic, people have become accustomed to using applications to fulfill their daily needs [1]. This trend of changing consumption patterns has encouraged multinational companies such as Shopee, Spotify, and Netflix to use technology to expand the reach of services across national borders [2; 3]. In 2015, the Organization for Economic Co-operation and Development (OECD), through its Pillar 1 policy, recommended a taxation framework for digital transactions with additional criteria not limited to physical presence [4].

The OECD Pillar 1 policy framework seeks to reduce base and profit-shifting (BEPS) practices. The BEPS practice uses tax-haven countries as the basis for permanent establishment (PE). The OECD proposed a framework to reduce BEPS practices through the additional concept of significant economic presence (SEP) provisions in determining a PE [5].

The SEP concept is an alternative to expanding taxation rights in the income tax aspect for source countries, which are currently the only objects of value-added tax. The income earned by a company using a marketplace platform is not an object of income tax as long as a PE has not been formed. The formation of a PE determines taxation rights for business profits based on non-resident marketplace platforms [6].

This principle is in accordance with OECD provisions that no PE does not tax [7]. The no PE-no tax concept in the OECD model tax treaty framework is used by digital-based companies to determine their country of domicile, so that they can avoid being taxed by the country of source of income [8].

The terminology of physical presence as a condition for determining PE has become irrelevant in current development. The development of business models that utilize digital platforms needs to be adapted to OECD's SEP concept by reconstructing the concept of the meaning of

physical presence in determining a PE [9].

The development of digital-based cross-border transactions and the urge to review PE determinations using additional SEP criteria provide opportunities to expand taxation rights for income tax in source countries [10; 11].

This study hypothesizes that the significant economic presence criteria for determining permanent establishments expand income tax taxation rights for the source country. The research question is how to reconstruct the concept of the meaning of the physical presence of PE.

This study aimed to reconstruct the criteria for determining permanent establishment by using the terminology of physical presence, reconstruction of permanent establishment subjects, and reconstruction of permanent establishment objects.

The research objectives were achieved through the formulation of a reconstruction concept that uses the SEP concept from the OECD for Economic Cooperation and Development. Section a review the literature supporting the concept of reconstruction.

## **LITERATURE REVIEW**

### **Significant Economic Presence**

Minimizing the impact of double taxation results in a set of distributive policies. The OECD Framework Taxation rights on business profits can be imposed in the country of residence or country of source of income. Taxation rights rest with the source country if a PE is formed. PE is not limited to physical presence; the existence of significant economic transactions through online platforms fulfills the meaning of economic presence [6].

Referring to the OECD consultation document, the SEP concept can be used as an alternative for determining PE. The PE concept implies the existence of three criteria for cross-jurisdictional digital transactions, with additional provisions for determining the existence of economic activity that previously implied a physical presence [12]. The first factor of the SEP framework is the income-based factor, the second is the digital factor, and the third is the user-based factor [13].

The Task Force on Digital Economics determined three jurisdictional factors when applying the SEP concept. Income-based factors include the transaction type, income threshold level, and related administration. Digital factors include local domain names, digital platforms, and payment options. User factors are based on data that reflect participation levels, such as the number of monthly active users, number of final online contracts, and volume of digital content collected through digital platforms [14].

### **Physical Distancing as a New Order Behavior**

Community behavior during and after the Covid-19 pandemic changed to a new order. Social distancing policies are becoming a new habit that influences business development policies [15]. The new habit of keeping your distance becomes an opportunity for business development through services that get closer to the consumers. The new habit of social distancing is being utilized by business actors based on digital platforms to increase the growth of e-commerce transactions across their jurisdictional borders [16].

The development of business models that utilize social distancing policies has resulted in physical presence becoming irrelevant in determining PE. Changes in consumer behavior that provide opportunities for cross-border jurisdictional transactions do not necessarily change the taxation rights of income-source countries [17]. This transformation is driving a global debate regarding the allocation of taxation rights and the nexus. Tax treaty provisions requiring physical presence are irrelevant when applied to digital economic transaction actors [11]. To achieve fair taxation rights for countries involved in cross-border transactions, a synergy of nexus renewal is needed.

The nexus update is an alternative for realizing fair taxation rights for digital transactions to avoid tax arbitrage practices that lead to tax avoidance [18]. A nexus indicates that digital transaction actors across jurisdictional borders are committed to their tax obligations. For source

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countries, the income tax nexus is the first step for source countries to tax digital transaction actors, even without a physical presence in that country [19]. Digital-based cross-border transactions regulated by the tax treaty are based on the concept of lex specialist derogate lex generalists [20]. The next explanation explains the concept of the lex specialist derogate lex generalist in tax treaty policies.

### Lex Specialist Derogate Lex Generalist

The principle of lex specialist derogate lex generalist in international tax law means that specific provisions trump general provisions [21]. This view was previously expressed by Jeremy Betham, that specific legal provisions are a consideration for adjustments to general legal provisions, considering that special provisions are designed in more detail and rigor [22]. In the context of cross-border transactions, jurisdiction between two countries is regulated in a tax treaty so that the provisions therein trump the provisions that apply nationally in each country's tax treaty [23]. Regulating cross-border transactions that have been regulated in each country's tax treaty still creates some uncertainty in determining tax rights. Frequently changing economic conditions require economic actors to adapt quickly, but regulations governing digital transactions cannot be changed as quickly as in the digital economy [17]. Reflecting on tax evasion cases, digital economy actors take advantage of policy loopholes by playing with profit allocation, so that taxation in the country of source of income can be avoided. Therefore, there is a need to reorganize jurisdiction in taxation.

The complexity of legal arrangements between jurisdictions requires a complete and comprehensive understanding of international legal provisions by considering the legal structure, regulated activities, and behavior of regulated multinational companies [20].

The provisions in the articles of agreements between countries consider the sovereignty of the legal policies of each country, resulting in a comprehensive discussion of a tax treaty considering long-term relationships. This principle is firmly adhered to by each country in formulating a bilateral tax treaty known as the lex specialist derogate lex generalist [24]. This principle is considered when reconstructing the meaning of the physical presence of the determination of a PE, as stated in the articles on tax treaties [25].

## RECONSTRUCTION METHODOLOGY

### Research Paradigm

A research paradigm is a way to examine social reality [26]. In this study, the social reality is that the conditions for the development of cross-jurisdictional digital transactions are increasing, but this is not commensurate with taxation rights in the income tax aspect of the source country. This reality does not fully fulfill the fairness of the taxation rights of the source country with the country of domicile [27]. Cross-jurisdictional taxation rights are regulated in tax treaties that consist of various text collections [28].

The collection of text on tax treaties is the main research data, which is then reconstructed in three stages. Reconstruction of the reality of tax texts by providing new meanings can present more relevant and contextual meanings [29]. This study uses a qualitative research approach with in-depth descriptions of the reality of the research object [30; 31].

### Reconstruction Stages

Currently, the concept of determining a PE refers to the Organization for OECD and Development framework with physical presence criteria, in accordance with Article 5. The first stage of reconstruction is to reconstruct the meaning of physical presence in Article 5 using OECD SEP criteria. The next stage is to pay attention to the income earned by the company which has been fulfilled to become a PE.

Referring to the SEP concept, this considers the income, digital, and user aspects associated with the terminology of keeping distance as a new order and considers the lex specialist derogate

lex generalist principle as the basis for preparing the concept of reconstruction, which is presented in Figure 1.

Based on Figure 1, regarding the stages of reconstruction of the meaning of the physical presence of PE, there are three stages. The first stage involves the reconstruction of the concept of the meaning of the physical presence of PE. This reconstruction emphasizes the determination of foreign individuals and entities by using the OECD SEP concept.

The second stage is the reconstruction of the subject of PE, which emphasizes the subject of foreign individuals and entities as PE in the digital and user aspects. In the third stage, the reconstruction of permanent establishments emphasizes the income earned by foreign individuals and entities as permanent establishments.

In the following section, the reconstruction process that begins with the reconstruction of the concept of the physical presence of PE is presented.

### Reconstruction Results

#### Reconstruction of the Concept of the Meaning of Physical Presence PE

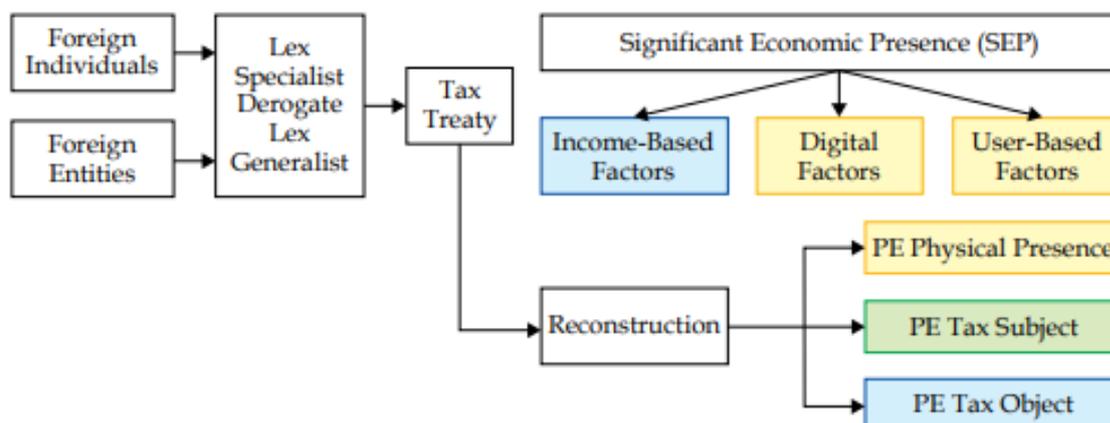
The first of these three stages reconstructs the meaning of physical presence in determining PE by determining foreign individuals and entities. The first stage of reconstruction involves determining the tax subject, followed by determining the tax object. Determining additional criteria for SEP as a development of physical presence is a new challenge, considering that each country has different definitions and jurisdictional provisions [32].

The first stage of reconstruction in the Indonesian context begins with a review of regulatory provisions related to electronic transactions and the concept of tax treaties. In 2022, after the pandemic, Indonesian tax authorities will adjust tax laws by enacting laws on the harmonization of tax regulations. Previously, regarding the regulation of electronic transactions, Indonesian tax authorities were only able to collect taxes on the value-added tax aspect and were not able to explore the income tax aspect.

Furthermore, Article 6, paragraph (6) of Law No. 2 of 2020 states that foreign traders, Foreign Service providers, and/or foreign PPMSE can be treated as PE and subject to income tax if they meet the provisions of significant economic presence.

The tax authority stipulates three provisions for significant economic presence: consolidated gross turnover of a business group up to a certain amount; sales in Indonesia up to a certain amount; and active users of digital media in Indonesia up to a certain number. Article 6, paragraph 6 of Law No. 2 of 2020 captures digital transactions in Indonesia. According to [33], the implementation of Law No. 2 of 2020 is a unilateral measure that has not yet reached global consensus. Ratification is required at the tax treaty level through the reconstruction of the meaning of the physical presence of PE.

Figure 1. Stages of Reconstruction of the Meaning of PE's Physical Presence



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In the reconstruction stage, the meaning of the physical presence of PE is illustrated by the Indonesian Tax Treaty with Singapore. The ratification of Indonesia's Tax Treaty with Singapore was carried out on February 4, 2020, and it became effective on January 1, 2022. There are several new agreements on the revised tax treaty. In terms of PE, there is no new agreement regarding its determination using the SEP concept of OCED. The new agreement is limited to changes in dividends, interest, royalties, and branch profit tax rates. Other agreements involve rearranging the exchange of information and anti-tax evasion<sup>3</sup>. This means that there was no change in Article 5, paragraph 1; therefore, PE refers to a permanent place of business in which all or part of a company's business is carried out. The emphasis in paragraph 1 is on the word place.

In this section, we have reconstructed the meaning of physical presence, highlighting the importance of physical presence terminology adapted to the current context. In the context of the development of digital transactions across jurisdictional boundaries without the physical presence of a transaction. The terminology of physical presence in the digital era should be adjusted to the meaning of economic presence, not just physical presence. After reconstructing the meaning of physical presence, the next explanation reconstructs the concept of a tax subject for cross-border digital transactions to become a tax subject in a country of source of income.

### Reconstruction of PE Tax Subject Concept

After going through the first stage of reconstruction, the second stage involves reconstruction of the subject aspect of income tax. In this reconstruction stage, we use illustrations of companies that use digital transactions across a country's jurisdictional boundaries.

Regarding value-added tax, tax contracts in Indonesia have gradually appointed multinational corporations to collect value-added tax. Considering the limited authority of Indonesian tax authorities in determining a PE, reconstructing the subject of income tax is relevant to creating taxation rights that are not limited to the value-added tax aspect.

Regarding the taxation of Google Asia Pacific Pte. Ltd., Sapore, whose place of business is in press releases no. SP-29 PMSE batch 1 (Google Asia Pacific Pte. Ltd.) was selected as the PMSE VAT collector on August 1, 2020<sup>5</sup>.

A tax is imposed on Google because it is deemed to have complied with the existing regulations, both in terms of transaction value and amount of traffic (access), within 12 months. Google charges 11% of the VAT (previously 10%) to Google accounts of customers who buy digital products or services in Indonesia (Google Workspace Edition). Buyers can provide Google with a taxpayer identification number (TIN) for VAT purposes to be printed on the buyer's invoice. Tax problems arise from the income tax aspect, where the Indonesian-Singapore tax treaty requires physical presence to measure the existence of PE [34].

Although Google Asia Pacific Pte. Ltd is indicated to have an SEP presence; it cannot be subject to income tax because there are no rules for SEP criteria [33]. This is because the two pillars of the discussion on digital economy taxation are agreed upon in an inclusive framework. One thing that is easily visible on pillar one is the right to taxation itself.

The right to tax electronic transactions across jurisdictional boundaries does not yet fulfill a sense of justice for the country of the source of income; currently, the right to tax still rests with the country of domicile. The implication is that the source country seeks to increase its tax potential in the context of local regulations in Indonesia through PMSE. Through the appointment of value-added tax collections, the Indonesian tax authority obtains increased tax revenue; however, this becomes the final burden on consumers.

Ideally, the increase in taxation rights takes the form of taxation rights on income received by digital transaction actors, which is the entity's obligation in the form of corporate tax. The concept promoted by the OECD through better policies for better lives is relevant in the context of fulfilling a sense of justice in taxation rights for income taxes in source countries [4; 14; 36]. Through the conceptual reconstruction of the meaning of the physical presence of a PE, digital transaction

opportunities across jurisdictional boundaries become tax subjects for the source country. Thus, income obtained from cross-border jurisdictional transaction business actors that meet the SEP criteria can become a tax object through the next reconstruction stage, related to the reconstruction of the concept aspect of the tax object.

### **Reconstruction of PE Tax Object Concept**

The third stage of the reconstruction was the tax-object aspect. Reconstruction at this stage is a reconstruction of the material aspects of the application of tax provisions after a digital transaction fulfills the formation of a PE and becomes a tax subject. In digital economic transactions across a country's jurisdictional boundaries, the income earned by an entity cannot be taxed in terms of income tax if the entity does not meet the requirements of a PE.

In the Indonesian context, taxation of PE is regulated by PMK-35/PMK.03/2019 for the determination of PE<sup>6</sup>. PE has the same tax obligations as corporate tax subjects in Indonesia, which are regulated in Article 2, paragraph (1a)<sup>7</sup>. According to Article 2, paragraph (5) of the Income Tax Law, PE is a form of business that is used by individuals who do not reside in Indonesia: individuals who are in Indonesia for no more than 183 days within a 12 month period, and entities that are not established and are not domiciled in Indonesia to run a business or carry out activities in Indonesia, such as building branch companies, factories, workshops, etc., which have facilities in the form of land and buildings and include equipment, machines, and warehouses owned or used by electronic transaction organizers to carry out business activities through the marketplace and are permanent. The development of digital economic transactions through online media and the internet has penetrated all levels of social life. The development of digital businesses does not include regional boundaries.

However, from a political perspective, each country still has territorial boundaries, and digital economic activities can be conducted anywhere and anytime. Producers, consumers, and distributors need not be present at one time or place to conduct the buying and selling transactions.

Therefore, it can be said that the flow of money in and out of a country is heavy. The outflow of money was heavy for countries that ruled the digital economy when many were positioned as consumers.

Governments in each country are currently fighting for a company or digital economic activity to be designated as a permanent establishment and carry out tax obligations in consumer countries. Currently, the issue of digital economy taxes is being intensively discussed, bearing in mind that Indonesia is one of the countries in Southeast Asia with the fastest and most rapid growth in the digital economy, so the government can attract the attention of entrepreneurs or digital economy rulers seeking profits.

In the emergence of this fact, the government has issued several regulations regarding tax regulations on digital economic activities with the aim of obtaining benefits from tax revenues. One is the plan to use the SEP concept with a specific form of implementation and format, although the government feels the need to wait for a decision and agreement from the OECD. Each country that has implemented this concept has a different format and form of implementation due to the absence of an official international definition. The government stipulates the provisions of the SEP concept through several specified criteria, including the consolidated turnover or income of business groups, and the ratio of sales in Indonesia to the number of active users of digital media (the Internet). If the determination of the PE cannot be imposed on foreign tax subjects because of a double tax avoidance agreement, foreign tax subjects who meet the SEP criteria are subject to an electronic transaction tax.

Indonesia recently established an Electronic Transaction Tax (PTE) in Law No. 2 of 2020, which refers to the domestic laws made so that they are not included in the tax treaty and result in value-added and income taxes that cannot be imposed in that country.

### Proposed SEP Concept as Criteria for Determining

Three stages of reconstruction have been presented in a structured manner, starting from reconstructing the meaning of the physical presence of a PE, continuing to reconstruct the concept of a PE's tax subject, and finally, reconstructing the concept of a PE's tax object. Reconstructing the meaning of physical presence in determining PE by adopting the SEP concept from OECD.

Tax subject reconstruction is further performed after a company meets the criteria for a PE. Thus, there is a taxation right for the source country of income on a tax subject that has been formed into a PE, through which income becomes a tax object.

The SEP concept proposal as a criterion for determining PE contains three aspects. Physical presence uses a new meaning with the criteria for determining whether there is income flowing from the user country. This means that Article 5, paragraph 1 of the tax treaty regarding PE, according to the illustration between Indonesia and Singapore after 30 years of revision on February 4, 2020, which became effective on January 1, 2022, should accommodate a proposal from the OECD regarding additional criteria for SEP as a determination of a PE.

In the context of the illustration in Indonesia, the adjustments made to the tax treaty between Indonesia and Singapore has not yet touched upon the terminology of physical presence. It is necessary to consider reviewing it by reflecting on the three stages of reconstruction through the meaning of physical presence, the concept of the tax subject, and the concept of the tax object in the aspect of corporate income tax. Thus, the income obtained by cross-border digital transactions becomes a tax object not only in the country of residence but also in the distributive right of the source country by considering the principle of *lex specialist derogate lex generalists* in the tax treaty concept.

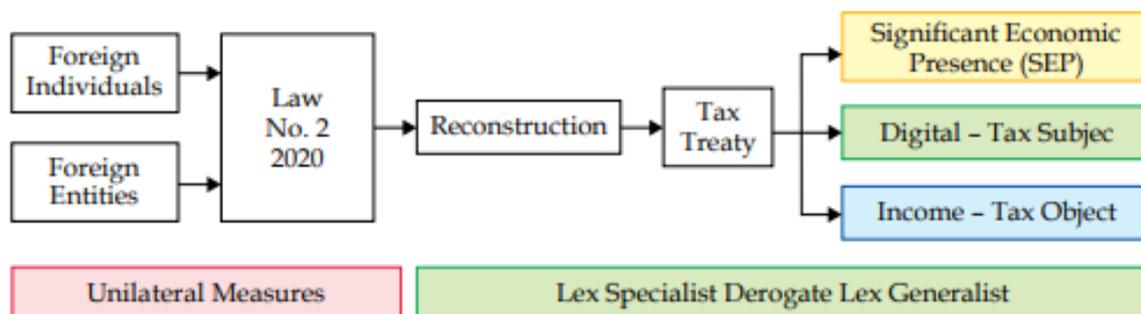
Reconsideration of the criteria for determining PE in Law No. 2 of 2020 needs to be expanded in scope and limited to PPMSE. Improvements, apart from the unilateral limited global consensus level, are required. This can be initiated by reviewing tax treaties with agreement partner countries with potential taxes on digital transactions [34–38]. This review aims to create legal certainty, considering that it is one of the factors considered by investors and encourages tax compliance [39–42].

The proposed reconstruction of the meaning of PE's physical presence using the new meaning of SEP from OECD is presented in Figure 2.

### DISCUSSION

Through three stages of reconstruction (the meaning of the physical presence, tax subject concept, and tax object concept), the meaning of determining physical presence as a criterion for determining a PE can answer the research hypothesis that additional SEP criteria as a determinant of a PE, the hypothesis of this research is that the SEP criteria in determining PE expand income tax taxation rights for the source country.

Figure 2. Reconstruction of the Meaning of PE's Physical Presence



The OECD makes PE a special concern in BEPS practices8 [4; 13]. Referring to Article 5,

paragraph 1 of the OECD Model Tax Treaty, it is stated that for the purposes of this convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on. The term fixed place of business in digital-based cross-border transactions is no longer relevant [5; 11; 32].

Reflecting on the OECD model, taxation rights for an entity’s profits are the country of domicile, unless a PE is formed in the source country [47]. This research hypothesis creates fairness taxation rights in the source country and the country of domicile by reconstructing the determination of a PE by adding SEP criteria, particularly for e-commerce transactions. The fairness taxation rights reflecting the business profit in accordance with Article 7 Tax Treaty OECD model, profits of an enterprise of a contracting State shall be taxable only in that State unless the enterprise carries on business in the other contracting State through a permanent establishment situated therein.

The proven hypothesis is that the SEP criteria for determining a PE seek to provide fairness in the taxation rights of the PE’s profits. Revisions are needed for articles governing PE in tax treaties and the expansion of jurisdictional coverage, in accordance with research results [50].

The derivative implications of its implementation can be achieved through various tax-incentive policies. It is necessary to pay attention to research results [51] that tax uncertainty in e-commerce transactions can have a negative impact on the growth of e-commerce transactions. Research [52] confirms that the development of trade leads to a digital-based virtual environment. Therefore, when additional SEP criteria are applied to determine PE, there must be a special policy for the affected entity.

Several studies related to tax incentives to increase investments have been applied to electric cars in renewable energy development and other derivative industries [53–56]. Through additional SEP criteria, determining a PE does not reduce the growth of e-commerce transactions with appropriate tax policy incentives and provides fairer taxation rights to the source country without ignoring the taxation rights of the country of domicile. According to the OECD tag line, better policies for better lives can be reflected through this hypothesis of fairness in taxation rights.

## **CONCLUSIONS**

Answering research questions related to how to reconstruct the concept of the meaning of the physical presence of a PE is described in three stages. In the first stage, the SEP concept proposed by the OECD was adopted. The second stage goes through further reconstruction after a digital transaction fulfills a PE and is subject to an income tax. After the final reconstruction is fulfilled, it becomes a PE, in accordance with the OECD concept that there is no PE-no tax. Then, the reconstruction leads to the fulfilment of the PE criteria as a subject of income tax, so that income received from the source country becomes an object of income tax.

This study tests a hypothesis regarding the application of the SEP concept to determine a PE that can increase the taxation rights of the income source country. This hypothesis is accepted and proven through three stages of reconstruction: reconstructing the meaning of physical presence, reconstructing the concept of the tax subject, and reconstructing the tax object; taxation rights can be increased in the income tax aspect.

This study makes theoretical and practical contributions to all parties who care about the fairness of taxation rights in transactions across jurisdictional boundaries. The new habit of social distancing created by the pandemic has become a driving force for the growth of digital transactions across jurisdictional borders and should be used as momentum to ratify tax treaties by presenting SEP terminology as an additional criterion for determining a PE. The OECD considers three factors through the SEP concept: income-based, digital, and user-based factors. The OECD consultation in the form of the SEP concept is a manifestation of the OECD’s role in presenting impartial policies to increase the fairness of taxation rights between source and domicile countries by considering the principle of *lex specialist derogate lex generalists* in the tax treaty concept.

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This study is only conceptual, and further research more specific to certain subjects, objects, and partner countries is required. The researcher presented this idea to strengthen the view and increase self-confidence in Pajak Kuat Indonesia Hebat.

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