



AVOIDANCE OR CIRCUMVENTION OF PERMANENT ESTABLISHMENT (PE) STATUS

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Abstract

This study explores the phenomenon of Permanent Establishment (PE) avoidance and evasion in Indonesia by examining how multinational companies design their business arrangements to limit tax exposure in the source country. Using an analytical approach that combines regulatory analysis, illustrative cases, and evidence from prior empirical studies, the paper uncovers several recurring practices, including the appointment of ostensibly independent agents, the deliberate separation of operational activities, the maintenance of minimal physical operations, and the increasing reliance on digital business models. In addition, the research reviews the alignment and performance of Indonesia's domestic tax framework with OECD standards, while emphasizing ongoing difficulties arising from complex corporate structures, the rapid expansion of digital transactions, and unequal access to information between taxpayers and tax authorities. The results demonstrate that although Indonesia has formally incorporated internationally recognized rules, their effectiveness is constrained at the implementation level. Accordingly, the study highlights the need to reinforce oversight mechanisms, enhance international tax cooperation, and adopt a significant economic presence concept to more accurately address digitalized and cross-border economic activities. This research advances the academic discussion on PE-related tax avoidance and offers policy-relevant insights for legislators, tax administrators, and future researchers.

Keywords: Permanent Establishment, PE avoidance, tax evasion, multinational enterprises, Indonesia, digital economy, Base Erosion and Profit Shifting (BEPS)

INTRODUCTION

The notion of Permanent Establishment (PE) is a core element of the international tax framework because it serves as the legal basis for a source jurisdiction to levy tax on the business income of a foreign entity operating within its borders. According to the OECD Model Tax Convention, a PE is a fixed place through which an enterprise conducts all or part of its commercial activities. This concept operates as the key criterion for distributing taxing rights between the country where income is generated and the country where the enterprise is resident. Once a PE is deemed to exist, the source state is permitted to tax profits that can be economically attributed to activities carried out in its territory.

Amid globalization, the growing sophistication of cross-border corporate arrangements, and the acceleration of the digital economy, the relevance of the PE concept has intensified while simultaneously giving rise to debate. Contemporary business practices enable multinational enterprises (MNEs) to gain substantial economic benefits from a market without establishing a meaningful physical footprint. As a

result, the scope of PE has expanded beyond traditional physical forms such as offices or manufacturing facilities. It may now also be triggered by the involvement of dependent agents who regularly finalize contracts or effectively contribute to their conclusion on behalf of a foreign enterprise.

Notwithstanding its central role in international taxation, the concept of Permanent Establishment has frequently been manipulated by multinational enterprises through carefully designed structures intended to prevent the recognition of a PE. Typical approaches involve deliberately splitting business functions so that each activity appears merely preparatory or auxiliary, and channeling operations through agents formally classified as independent to escape PE qualification. Although these structures may technically align with the explicit language of tax treaties, they often undermine the spirit and objectives of international tax principles. Consequently, such practices are commonly viewed as tax avoidance rather than acceptable or genuine tax planning.

These issues led the Organisation for Economic Cooperation and Development (OECD) to specifically target the artificial circumvention of Permanent Establishment status through the Base Erosion and Profit Shifting (BEPS) Action 7 initiative. The Final Report of BEPS Action 7 introduced substantial modifications to the PE concept in the OECD Model Tax Convention, to align taxation more closely with the location of real economic activity and value creation. Through these changes, the revised approach is intended to reinforce the taxing authority of source jurisdictions by expanding the conditions under which a PE can be recognized.

In the Indonesian context, concerns surrounding Permanent Establishment avoidance are especially pronounced. As a country that attracts substantial foreign direct investment and hosts an expanding digital economy, Indonesia faces significant challenges in protecting its domestic tax revenues. Weak or inadequate PE rules can result in significant fiscal losses, particularly when overseas companies derive substantial profits from the Indonesian market without creating a taxable nexus. In addition, the application of Indonesia's domestic PE regulations must be reconciled with its commitments under Double Taxation Avoidance Agreements (DTAAs), further complicating the interpretation and enforcement of PE-related provisions.

Based on these considerations, this research examines the Permanent Establishment concept and the various methods used in international tax practice to avoid PE recognition. The study explores the underlying drivers of such avoidance, with particular emphasis on cross-border transactions and digitalized business models. It assesses the capacity of Indonesia's domestic tax rules and treaty arrangements to address these issues. Through this analysis, the research seeks to add to the broader discussion on equity in international taxation, the proper distribution of taxing powers, and the effectiveness of current legal regimes in addressing the changing landscape of global commercial activities.

LITERATURE REVIEW

Permanent Establishment as the Basis of Source Taxation

International taxation developed as a practical solution to the growing transnational flows of capital, workforce mobility, and commercial operations, which revealed the inadequacy of tax regimes confined to national borders. During the early decades of the twentieth century, governments increasingly encountered disputes over the authority to tax income, especially between the countries where income originated and those where taxpayers were resident. Such concurrent assertions of taxing power often led to double taxation, creating legal ambiguity and acting as a barrier to cross-border commerce and investment (Arnold, n.d.).

The earliest international initiatives to address these challenges were carried out under the League of Nations during the 1920s and 1930s. These efforts resulted in the 1928 Model Tax Conventions, which established the initial principles for allocating taxing rights between contracting states. Although they were not legally binding, these models introduced essential concepts, including the distinction between business income and passive income and the requirement of a sufficient economic connection as a basis for taxation. These principles continue to influence contemporary tax treaty practice, as Kobetsky noted in 2011. Most importantly, the models represented the first systematic attempt to balance the fiscal interests of source countries and residence countries within a coordinated international framework.

After the Second World War, international tax coordination advanced markedly with the creation of the Organisation for Economic Cooperation and Development. The release of the OECD Model Tax Convention in 1963 marked a decisive move toward greater uniformity in the negotiation of bilateral tax treaties. This model offered a detailed, systematic framework to mitigate double taxation, curb tax avoidance, and encourage international economic interaction by strengthening legal predictability (OECD, 2017). Over the subsequent decades, the OECD Model emerged as the primary benchmark for tax treaty design worldwide, a position that reflects both the economic weight of OECD member countries and their leading role in shaping international tax policy standards (Forbes, 2020).

Alongside the initiatives undertaken by the OECD, the United Nations formulated its own Model Double Taxation Convention to respond to the distinct needs and priorities of developing economies. The UN Model assigns greater weight to source-based taxation by granting the country where economic activities are carried out broader taxing powers. This orientation acknowledges that developing nations often depend more on source country taxation and may face limitations in administrative resources to effectively tax income earned abroad by resident taxpayers (United Nations, 2011). Consequently, many developing states, including Indonesia, adopt a pragmatic approach to treaty negotiations by selectively incorporating elements from both the OECD and UN Models to maintain an appropriate balance between attracting foreign investment and safeguarding domestic tax revenues.

During the closing decades of the twentieth century and the beginning of the twenty-first century, the international tax system underwent significant change, influenced by globalization, more profound financial interconnectedness, and the expansion of digital business models. Tax treaty principles, initially designed for an economy based on physical presence and clearly defined geographic activities, have become progressively less effective in confronting profit-shifting practices used by multinational enterprises. As a result, the emphasis of international tax policy evolved from a primary objective of preventing double taxation to a broader focus on combating tax base erosion and increasingly aggressive forms of tax avoidance (OECD, 2021).

The OECD and G20 Base Erosion and Profit Shifting project illustrates this evolution by focusing on inherent vulnerabilities within the international tax architecture, particularly treaty-based arrangements that enable profits to be separated from the locations of real economic activity. Measures such as BEPS Action 7, which seeks to counter the artificial circumvention of permanent establishment recognition, reflect an increasing awareness that long-standing tax principles must be adapted or fundamentally revised to remain relevant in an increasingly global and digital economic environment. Present-day international tax cooperation has therefore expanded beyond treaty drafting to include enhanced transparency, the systematic exchange of information, and the adoption of global minimum tax rules (OECD, 2021).

In summary, the development of international taxation demonstrates a steady progression from basic forms of intergovernmental coordination to an intricate, layered framework designed to align national taxing authority with the demands of an increasingly integrated global economy. This historical background is crucial for understanding the emergence of the permanent establishment concept and the ongoing difficulties surrounding its circumvention in contemporary international tax practice.

Evolution of the Permanent Establishment Concept and Its Structural Weaknesses

The notion of Permanent Establishment (PE) occupies a central position in the international tax system, as it serves as the primary legal basis for source jurisdictions to tax business income earned by foreign enterprises. The development of the PE concept has progressed alongside the expansion of international tax treaties and reflects the growing complexity of cross-border commercial activities.

In its original formulation, the concept of Permanent Establishment emerged from the international tax treaty framework developed by the League of Nations during the 1920s. At that time, a PE was generally understood as a stable, tangible presence in a foreign jurisdiction, typically in the form of an office, branch, manufacturing facility, or workshop. This understanding was consistent with the economic conditions of the era, when engaging in cross-border trade often required a physical presence in the market country (Van der Bruggen, n.d.). The early design of the PE concept sought to balance the fiscal claims of source and residence states by granting taxing rights to the source country only when the foreign enterprise maintained

a substantial and enduring presence there. Accordingly, the PE requirement operated as a threshold mechanism, ensuring that merely occasional or insignificant business activities did not give rise to source-based taxation (Lang & Reimer, 2021).

A significant development in the Permanent Establishment concept occurred with the introduction of the OECD Model Tax Convention in 1963, followed by subsequent amendments. Within the OECD Model, a PE is defined as a fixed location through which an enterprise conducts all or part of its commercial operations, highlighting three essential components: a place of business, a degree of permanence, and the carrying on of business activities (OECD, 2017). In addition to conventional physical establishments, the OECD Model expanded the scope of PE by recognizing particular forms, including construction-related establishments determined by the length of a project and agency-based establishments arising when agents possess the authority to act on behalf of a foreign enterprise. These rules demonstrate an effort to adapt the PE concept to a broader range of commercial arrangements, especially those involving intermediaries or representatives operating within the source jurisdiction (Avery Jones, 2006).

Nevertheless, the provisions of the OECD Model also contain inherent structural gaps that multinational enterprises may use to circumvent the recognition of Permanent Establishment status. Such practices include restricting agents' formal authority or dividing business functions so they appear to fall within preparatory or auxiliary categories. These arrangements have generated ongoing debate regarding whether the PE concept remains effective in protecting the tax base of source jurisdictions.

To accommodate the interests of developing economies, the United Nations Model Double Taxation Convention applies a comparatively more expansive interpretation of Permanent Establishment. The UN Model generally strengthens source country taxing rights by broadening the criteria for agency-based establishments and by setting lower thresholds than those in the OECD Model (United Nations, 2011). This orientation reflects the practical circumstances of developing states, which frequently host substantial economic activity while possessing more limited negotiating leverage in treaty discussions. As a result, the PE concept under the UN Model is designed to reduce the risk of profits being shifted to the country of residence without a fair level of taxation in the jurisdiction where the economic activity actually occurs (Arnold, n.d.).

In today's economic environment, shaped by globalization and rapid digitalization, the Permanent Establishment concept faces growing, multifaceted challenges. Multinational enterprises can now derive significant economic value from a jurisdiction without maintaining a physical presence that meets the conventional requirements for a PE. As a result, enterprises may formally avoid PE recognition despite having a meaningful economic footprint, thereby creating opportunities for tax avoidance.

In response to these developments, the OECD's Base Erosion and Profit Shifting initiative implemented a series of reforms, most notably through BEPS Action 7, to counter practices that deliberately

avoid the recognition of Permanent Establishment status. These measures involve strengthening the rules on agency-based establishments and narrowing the scope of exemptions for activities characterized as preparatory or auxiliary, which had frequently been used to escape source-based taxation (OECD, 2013). This progression illustrates a movement away from an approach centered solely on physical presence toward one that places greater weight on economic substance, providing an essential framework for examining PE avoidance and evasion within the modern international tax landscape.

Treaty Shopping and Permanent Establishment Avoidance Strategies

Treaty shopping describes a strategy in which multinational enterprises design their transactional structures or legal frameworks to take advantage of preferential provisions in double taxation agreements to reduce their overall tax burden. This practice commonly involves channeling income through jurisdictions with more favorable treaty terms with the source country, even when the intermediary entity lacks meaningful economic substance or genuine commercial activity (Butarbutar, 2023). Such arrangements conflict with the fundamental objectives of tax treaties, which seek to ensure an equitable allocation of taxing rights between source and residence jurisdictions, eliminate double taxation, and limit opportunities for overly aggressive tax planning.

The widespread use of treaty shopping has been encouraged by specific structural characteristics of Permanent Establishment provisions within double taxation agreements. Numerous treaties provide exemptions or reduced withholding tax rates for specific categories of income, including dividends, interest, and royalties, which multinational enterprises can exploit by inserting intermediary entities in third jurisdictions. As a consequence, source-country taxation may be significantly reduced or entirely avoided, even though the underlying economic activities are carried out within the source state (Haryowardani & Verry, 2023).

Strategies aimed at avoiding Permanent Establishment status generally involve organizing business activities to prevent the formation of a taxable nexus in the source jurisdiction. Multinational enterprises frequently take advantage of the flexibility embedded in Permanent Establishment definitions under double taxation agreements, including restrictions on agency-based establishments, exclusions for activities classified as preparatory or auxiliary, and minimum duration requirements for construction projects, to sidestep source-country tax liabilities. Common approaches include the following.

1. Agency arrangements are structured so that local representatives lack formal authority to bind the enterprise legally, thereby avoiding qualification as a permanent establishment.
2. Fragmentation of activities occurs when core commercial functions are deliberately split into smaller components that are characterized as ancillary or preparatory and therefore fall outside the scope of the Permanent Establishment definition.

3. The use of intermediary entities involves channeling transactions through jurisdictions that benefit from favorable treaty provisions to lower withholding taxes or prevent the recognition of a Permanent Establishment in the source country.

These practices demonstrate the limitations of traditional Permanent Establishment concepts, which were grounded mainly in physical presence, in accurately reflecting the economic reality of contemporary cross-border business models, particularly those operating within the digital economy (OECD, 2013).

In response to treaty shopping and strategies aimed at avoiding Permanent Establishment recognition, international tax authorities have introduced a range of corrective measures. Through the Base Erosion and Profit Shifting initiative, particularly Actions 6 and 7, the OECD seeks to curb treaty misuse and the artificial circumvention of PE status. Central elements of these reforms include the following.

1. Restrictions on treaty benefits are implemented through anti-abuse mechanisms, such as the Principal Purpose Test, which denies access to treaty benefits where arrangements are primarily designed to obtain tax benefits rather than to serve genuine commercial objectives.
2. Refinements to Permanent Establishment definitions involve providing more explicit guidance on agency-based establishments, construction-related establishments, and the scope of exemptions for preparatory or auxiliary activities, thereby reducing opportunities to avoid creating a taxable nexus.
3. Stronger substance requirements require intermediary entities that seek to rely on treaty protections to demonstrate real economic presence and meaningful activities in the jurisdiction where they are established.

Together, these measures illustrate a broader international movement toward harmonizing formal legal concepts of Permanent Establishment with underlying economic substance, to preserve the taxing rights of source jurisdictions over income generated through significant activities within their borders (OECD, 2015).

Treaty shopping and the avoidance of Permanent Establishment status carry serious consequences for source jurisdictions, particularly through the erosion of tax bases and the decline of public revenues. Although double taxation agreements are intended to encourage international investment and economic cooperation, they must also strike an appropriate balance between facilitating cross-border activity and preventing abusive tax practices. Well-defined Permanent Establishment rules, robust anti-abuse provisions, and more rigorous substance requirements enhance the capacity of tax treaties to allocate taxing rights effectively and to limit aggressive tax planning.

The expansion of the digital economy further intensifies these challenges. Numerous multinational enterprises can generate substantial income within a country without creating a conventional Permanent Establishment, underscoring the need for revised treaty interpretations or alternative frameworks capable

of recognizing significant economic involvement that is not tied to physical presence (Giuliano & Rondelli, 2025).

Ultimately, confronting treaty shopping and Permanent Establishment avoidance is vital for preserving the credibility and sustainability of international tax regimes. Coherent legal structures, combined with consistent and effective enforcement, help ensure that multinational enterprises make a fair tax contribution in the jurisdictions where economic value is produced, while maintaining the intended advantages of bilateral tax treaty networks.

BEPS Action 7 and Its Limitations

The OECD Base Erosion and Profit Shifting initiative, through Action 7, directly targets practices designed to avoid the recognition of Permanent Establishment status artificially. This action responds to the growing reality that multinational enterprises can engage in substantial economic activities within a jurisdiction without meeting the traditional thresholds for establishing a Permanent Establishment. The primary objective of Action 7 is to reassert and protect the taxing rights of source countries. Its core measures can be summarized as follows.

First, Action 7 refines the concept of agency-based Permanent Establishment by narrowing the scope of exceptions previously available to dependent agents. Under the revised approach, agents acting on behalf of an enterprise may constitute a Permanent Establishment even when their activities were formerly characterized as preparatory or auxiliary. Second, the reforms address the artificial separation of business functions. Action 7 limits enterprises' ability to fragment core operations into smaller activities that, individually, fall outside the Permanent Establishment definition but collectively constitute substantive business activity. Third, the action targets commissionaire arrangements and similar contractual structures. These arrangements had allowed enterprises to avoid Permanent Establishment recognition by operating through intermediaries or specific contractual forms in the source jurisdiction while retaining effective control over business operations (OECD, 2015).

By prioritizing economic substance over formal legal characterization, Action 7 marks a significant shift toward ensuring that profits arising from meaningful activity within a source country are subject to appropriate taxation.

The implementation of Action 7 carries important consequences for the interpretation of double taxation agreements and domestic tax regimes. Jurisdictions adopting its principles are encouraged to revise bilateral treaties or apply the underlying standards through domestic legislation in order to deny Permanent Establishment status to arrangements that lack genuine commercial substance. This development has resulted in more detailed scrutiny of the roles performed by dependent agents, the duration and nature of

construction activities, and the classification of preparatory operations, thereby strengthening source-based taxing rights.

Notwithstanding the progress achieved through BEPS Action 7, several constraints continue to limit its overall effectiveness. First, its practical impact is heavily influenced by how individual countries transpose the Action 7 principles into their domestic legislation and bilateral tax treaties. Variations in implementation can result in uneven application and reduced consistency across jurisdictions. Second, the enforcement of the revised Permanent Establishment standards presents significant administrative challenges. Assessing whether specific activities qualify as preparatory or auxiliary, or instead amount to the creation of a taxable presence, requires extensive factual examination. This process can be resource-intensive for tax authorities and increases the likelihood of interpretative disagreements and disputes. Third, the expansion of the digital economy exposes shortcomings that remain even after the Action 7 reforms. Business models that generate substantial economic value without a physical footprint may still fall outside traditional Permanent Establishment thresholds, leaving unresolved gaps in the taxation of digital activities (Giuliano & Rondelli, 2025). Fourth, political and treaty-related constraints may hinder broader adoption. Revising existing tax treaties or fully integrating Action 7 standards often depends on the consent of treaty partners, which can slow reform efforts and limit the degree of international harmonization.

These limitations highlight the ongoing need to refine international tax rules to address evolving patterns of cross-border trade and digital commerce. Although Action 7 enhances source country taxing rights and curtails artificially constructed Permanent Establishment arrangements, it cannot, on its own, eliminate all risks associated with base erosion and profit shifting. Additional instruments, including robust anti-treaty shopping provisions, stricter substance requirements, and coordinated approaches to digital taxation, are necessary to address emerging challenges while preserving the balance between investment promotion and equitable taxation.

Overall, BEPS Action 7 constitutes an important milestone in modernizing the Permanent Establishment concept by more closely linking tax obligations to economic substance. At the same time, its limitations illustrate the persistent tension between treaty design flexibility, administrative enforcement capacity, and the rapidly changing global business landscape (OECD, 2021).

Empirical and Jurisprudential Studies on Permanent Establishment Avoidance

Empirical evidence indicates that multinational enterprises frequently design their operational structures to limit the emergence of Permanent Establishments in jurisdictions with relatively high tax rates. Research across OECD member states reveals that firms commonly separate essential business functions into preparatory or auxiliary activities, or rely on intermediary entities, to avoid meeting Permanent

Establishment thresholds and thereby lower the amount of profit subject to source-based taxation (Kudla et al., 2023).

Quantitative studies further highlight a relationship between economic imbalances and the likelihood of Permanent Establishment avoidance. Jurisdictions with smaller economies or weaker negotiating positions in tax treaty discussions tend to agree to Permanent Establishment definitions more favorable to foreign investors, thereby increasing opportunities for profit shifting. Through these arrangements, multinational enterprises can lawfully allocate income to low-tax jurisdictions without breaching treaty commitments, thereby diminishing the source country's tax base (OECD, 2021).

In addition, analyses of global tax treaty networks show that countries maintaining extensive webs of bilateral agreements are more exposed to Permanent Establishment avoidance through treaty shopping. Multinational enterprises take advantage of variations in treaty language and inconsistencies in Permanent Establishment standards to optimize their tax positions, a pattern consistently identified in cross-country empirical research (Giuliano & Rondelli, 2025).

Judicial decisions offer valuable insights into how courts and tax authorities interpret the Permanent Establishment concept to address avoidance practices. Several significant cases illustrate these interpretative approaches.

In *Hyatt International v. India*, decided in 2025, the Supreme Court of India ruled that a Permanent Establishment located in India is subject to taxation on income attributable to its domestic activities, irrespective of whether the multinational group as a whole reported global loss. The judgment reaffirmed that tax liability is determined by the economic substance of activities carried out within the jurisdiction, rather than by the enterprise's overall financial outcome (Indu Bhan, 2025).

In the *Gold Trading* cases involving Germany and the United Kingdom, the German Federal Tax Court considered whether the use of short-term business facilities in another country could constitute a Permanent Establishment under applicable bilateral treaties. The court concluded that both the length of time and the continuity of business activities are critical factors in establishing a Permanent Establishment, thereby illustrating the challenges of applying traditional Permanent Establishment criteria to temporary or fragmented business arrangements (Petersen & Lange, 2025).

The *Energias de Portugal* case from 2017 highlighted the importance of procedural compliance in accessing treaty benefits. The court held that even where a Permanent Establishment may exist, entitlement to treaty relief depends on the submission of appropriate documentation, including a valid Certificate of Domicile. The absence of such documentation was found to justify the application of domestic taxation, demonstrating the interaction between substantive Permanent Establishment rules and procedural anti-avoidance mechanisms (Septriadi & Darussalam, 2017).

Judicial practice and regulatory experience highlight several recurring themes in the application of Permanent Establishment rules. First, courts increasingly emphasize the underlying economic reality of business activities rather than their formal legal characterization when assessing whether a Permanent Establishment exists. This substance-based approach aims to prevent artificial structures from obscuring genuine taxable presence. Second, procedural and administrative requirements play a decisive role in the enforcement of Permanent Establishment provisions and access to treaty benefits. Proper documentation, including evidence of tax residence or beneficial ownership, is often a prerequisite for invoking treaty protections, and noncompliance may result in the application of domestic tax rules. Third, asymmetries in treaty negotiations can significantly affect exposure to Permanent Establishment avoidance. Countries with limited bargaining power or less developed domestic tax frameworks are generally more susceptible to profit shifting practices, as their treaty provisions may offer broader opportunities for avoidance. Finally, the expansion of digital and intangible business models exposes fundamental limitations in Permanent Establishment concepts that rely primarily on physical presence. Income derived from digital platforms or remote services often escapes traditional nexus rules, reinforcing the case for redefining Permanent Establishment standards to incorporate the concept of significant economic presence (Giuliano & Rondelli, 2025; OECD, 2025).

Empirical findings and judicial experience collectively point to the necessity of revising Permanent Establishment rules in several key respects. Reforms are required to ensure that source jurisdictions retain the ability to tax profits generated through meaningful economic activity within their territory. At the same time, regulatory frameworks must be designed to restrict the use of artificial arrangements intended solely to avoid the recognition of Permanent Establishment status.

In addition, existing definitions of Permanent Establishment need to be adjusted to accommodate the realities of digitalization, platform-based business models, and remote service provision, which frequently operate beyond the reach of traditional physical presence criteria. Stronger administrative controls and more rigorous documentation requirements are also essential to reduce treaty abuse and improve the effectiveness of enforcement mechanisms.

Taken together, the evidence indicates that although Permanent Establishment avoidance continues to pose a serious challenge, its impact can be reduced through a coordinated approach that combines substantive legal reform, enhanced administrative enforcement, and practical international cooperation. When aligned with the principles underlying BEPS Action 7, such measures help limit tax base erosion and promote a fairer distribution of taxing rights among jurisdictions.

ANALYTICAL APPROACH

Definition and Regulations of Permanent Establishment (PE) in Indonesia

Under Indonesian tax law, a Permanent Establishment is a form of business presence through which a foreign taxpayer carries out commercial activities in Indonesia. This concept is expressly governed by Article 2 paragraph 5 of the Indonesian Income Tax Law, which provides that a Permanent Establishment may take the form of a place of management, branch or representative office, office premises, manufacturing facilities, workshops, storage facilities, as well as construction, installation, or assembly projects utilized for business operations within Indonesia (Law No. 7 of 1983 as amended by Law No. 36 of 2008). The Indonesian definition of Permanent Establishment, therefore, emphasizes the existence of a sustained physical presence accompanied by ongoing business activities in the country.

In addition, Article 2, paragraph 5 of the Income Tax Law specifies that a Permanent Establishment is regarded as a foreign taxpayer that is liable to Indonesian income tax on earnings derived from sources within Indonesia. This classification is grounded in the view that, even though the taxpayer is neither incorporated nor resident in Indonesia, the existence of a physical presence combined with business activities establishes a sufficient economic connection to justify taxation. From a conceptual perspective, Darussalam and Septiadi (2017) observe that Indonesia's regulation of Permanent Establishment continues to reflect a traditional, physical presence-based model, requiring a fixed place of business effectively used to carry out commercial activities. In the absence of such elements, a foreign enterprise is generally not treated as having a Permanent Establishment. Consequently, while the statutory definition of Permanent Establishment under Indonesian law serves as the core reference for determining tax liability, it simultaneously leaves room for avoidance or circumvention through the deliberate structuring of cross-border business operations.

In response to evolving international business practices and to strengthen legal clarity, the Indonesian government periodically issues implementing regulations that further define the scope and responsibilities of Permanent Establishments. One of the most recent and significant measures is Minister of Finance Regulation Number 172 of 2023, which came into force on December 29, 2023, and places particular emphasis on transactions between a Permanent Establishment and its related parties. This regulation requires a Permanent Establishment to apply the Arm's Length Principle to related-party dealings and to disclose information on intra-group transactions connected to its activities in Indonesia. Through these requirements, the regulation seeks to bring Indonesia's tax framework into closer alignment with international transfer pricing standards while reducing opportunities to avoid Permanent Establishment recognition through the use of affiliated corporate structures.

In addition, Minister of Finance Regulation Number 35/PMK.03/2019 sets out the administrative framework governing the recognition of Permanent Establishments, including obligations related to

registration and the acquisition of a taxpayer identification number. Under this regulation, foreign enterprises conducting business through a Permanent Establishment are required to register within one month of commencing activities in Indonesia and to comply with the applicable compliance and deregistration procedures. These administrative requirements enhance supervisory control and help limit formal strategies aimed at avoiding Permanent Establishment status through delayed or incomplete registration.

Furthermore, the taxation of Permanent Establishment income and the imposition of Branch Profit Tax are governed by the amended Indonesian Income Tax Law under the Law on the Harmonization of Tax Regulations. Under this framework, net profits earned by a Permanent Establishment after corporate income tax are subject to a branch profit tax at a rate of 20 percent, unless a lower rate applies pursuant to an applicable Double Taxation Avoidance Agreement. This rule is intended to ensure that profits generated through a Permanent Establishment cannot be remitted abroad without an additional layer of taxation that reflects Indonesia's domestic fiscal policy objectives.

In international taxation, the concept of a Permanent Establishment is widely recognized and is a core element of many national tax regimes. A large number of jurisdictions rely on Article 5 of the OECD Model Tax Convention as the principal international benchmark, which centers on the existence of a fixed place of business through which business activities are carried out. Under the OECD framework, Permanent Establishments are generally categorized into fixed place establishments, construction-related establishments, and establishments arising from the activities of dependent agents. This classification emphasizes the economic substance and functional reality of business operations rather than their formal legal structure alone.

In the United States, the concept of Permanent Establishment is applied primarily through tax treaty provisions. In contrast, domestic tax law focuses on whether a foreign entity is engaged in a trade or business within the United States. Despite this distinction, U.S. practice generally requires either physical presence or the involvement of an agent with authority to bind the foreign enterprise legally. At the same time, U.S. tax law applies a relatively strict assessment of activities classified as preparatory or auxiliary, so that the mere existence of a physical presence does not automatically give rise to Permanent Establishment status (Cockfield, 2017).

By contrast, India applies a broader and more assertive interpretation of Permanent Establishment by combining the OECD-based definition with its domestic concept of business connection, enabling taxation even where physical presence is relatively limited. In addition, India incorporates anti-fragmentation provisions into its tax treaties to counter strategies that divide business operations into separate activities to avoid creating Permanent Establishment status.

Compared with these jurisdictions, Indonesia's approach to Permanent Establishment regulation is more cautious and formal, placing strong emphasis on physical presence and the duration of business activities as stipulated in the Income Tax Law. Although this framework provides a high level of legal certainty, its reliance on formal thresholds creates opportunities for foreign enterprises to engage in substantial economic activities in Indonesia without meeting the criteria for Permanent Establishment recognition. A comparative perspective demonstrates that variations in national Permanent Establishment regimes reflect differing policy choices in reconciling the objectives of legal predictability with the need to address tax avoidance effectively.

Forms of Avoidance and Evasion of Permanent Establishments (PE)

Multinational corporations have a strong economic incentive to avoid recognition of a Permanent Establishment in source jurisdictions, as establishing a PE triggers income tax liabilities on profits earned in that country. In practice, strategies aimed at avoiding PE status are typically carried out through careful legal and operational arrangements that ensure the enterprise does not formally satisfy the Permanent Establishment requirements set out in domestic tax legislation or applicable double taxation agreements (OECD, 2017).

A commonly employed method involves an independent agent arrangement, under which a multinational corporation designates a third party or related entity as an agent formally characterized as independent and without the legal authority to bind the foreign enterprise. Even though such an agent may perform economically significant functions, including sales activities, contract negotiations, or marketing efforts, the formal power to conclude contracts is intentionally retained outside the source jurisdiction. Through this structure, multinational corporations can claim that the conditions for the existence of a permanent establishment are not met (Avery Jones, 2006).

Multinational corporations also commonly make use of the classification of activities as preparatory or auxiliary in order to avoid Permanent Establishment recognition. Under the OECD Model Tax Convention, certain functions such as storage, information collection, or promotional activities are excluded from the definition of a Permanent Establishment. In practice, however, enterprises may expand the scope of these activities beyond their purely supportive character while continuing to claim exemption from Permanent Establishment status (OECD, 2017). In addition, activity fragmentation is frequently employed, whereby business functions are divided among several entities or locations so that each activity, when viewed in isolation, fails to satisfy the Permanent Establishment criteria. Although each component may appear ancillary on its own, the combined effect of these fragmented operations can amount to a significant and sustained business presence within the source jurisdiction (OECD, 2013).

Contract design also plays a critical role in strategies aimed at avoiding Permanent Establishment recognition. Multinational corporations often arrange their contractual relationships so that key decision-making authority, ownership of assets, and the assumption of significant business risks are formally allocated to entities located in low-tax jurisdictions. At the same time, operations in the source country are limited to routine or low-risk functions. Through this structure, enterprises argue that profits should not be attributed to activities performed in the source jurisdiction (Lang & Reimer, 2021). In specific industries, particularly the construction and service sectors, time-based strategies are also employed by dividing projects into several shorter contracts to remain below the duration thresholds that would otherwise give rise to a Permanent Establishment under applicable tax treaties. These practices demonstrate that Permanent Establishment avoidance often relies on strict adherence to formal legal requirements rather than the underlying economic realities of business operations, thereby complicating tax authorities' enforcement efforts. In response, international initiatives such as BEPS Action 7 promote a substance-over-form perspective to counteract artificially structured arrangements intended to avoid Permanent Establishment status (OECD, 2013).

The design of corporate structures is a decisive factor in assessing whether a Permanent Establishment arises within a source jurisdiction. Multinational corporations deliberately shape their organizational, operational, and contractual arrangements to manage tax exposure, including the risk of Permanent Establishment recognition. Through these structures, functions, assets, and risks are allocated across group entities, providing the framework for tax authorities to evaluate the existence of a sustained and taxable business presence (Lang & Reimer, 2021).

One frequently employed arrangement is the commissionaire model, where a local entity markets or sells goods for a foreign principal without becoming a formal party to the sales contracts. Because contractual authority remains with the foreign principal, income can be generated in the source country without triggering Permanent Establishment status, as the local entity is deemed legally unable to bind the enterprise (OECD, 2017). In a similar vein, limited-risk distributor structures confine the local entity's role to routine distribution activities. At the same time, strategic decision-making, ownership of intangibles, and the assumption of significant risks are retained by affiliated entities located abroad. As a result, a substantial portion of profits is allocated outside the source country, often to jurisdictions with more favorable tax regimes (Arnold, n.d.).

Corporate structures can also shift high-value activities, including strategic management, research and development, or supply chain oversight, to entities located in low-tax jurisdictions. Although routine operations may take place in the source country, multinational corporations often contend that profits should be attributed to the management of key decisions and risks carried out abroad. It demonstrates how corporate design can effectively decouple the site of economic activity from the site of tax liability (OECD,

2013). The use of such complex structures complicates tax authorities' ability to assess genuine economic presence, underscoring the growing importance of adopting a substance-over-form approach in Permanent Establishment evaluations.

The UN Model Double Taxation Convention places particular emphasis on the economic contributions of local entities within source countries, reflecting the perspective of developing nations that host significant multinational enterprise activity yet may face challenges in enforcing taxation due to intricate corporate arrangements (United Nations, 2011). More broadly, corporate structures are far from neutral in international taxation, as organizational and contractual design often serve as key mechanisms for avoiding Permanent Establishment. Assessing such structures, therefore, requires a holistic evaluation of economic substance, the functions performed, and the tangible contributions to profit generation within the source jurisdiction to ensure that taxation aligns with actual economic activity.

One prominent example of Permanent Establishment avoidance in Indonesia is the PT Bank Danamon Indonesia Tbk case, which illustrates the complexities involved in determining PE status. According to Haryowardani and Verry (2023), the dispute arose when the Directorate General of Taxes reassessed income considered attributable to the Bank's PE activities. The Bank subsequently filed an appeal and ultimately sought cassation. In Supreme Court Decision No. 919/B/PK/PJK/2015, the Court overturned the earlier ruling, emphasizing how both factual circumstances and interpretative judgment can complicate the recognition of a Permanent Establishment. This case highlights the difficulties tax authorities face in enforcing PE taxation, especially when multinational entities use legal and operational structures that obscure their substantive economic presence in Indonesia.

Digital and cross-border e-commerce activities pose emerging challenges for the application of Permanent Establishment rules in Indonesia. As Hendri, Rahayu, and Setyowati (2021) note, numerous digital enterprises can evade PE recognition because they lack a physical presence in the country, even though they generate substantial revenue from Indonesian customers. This gap in traditional PE definitions underscores the need for expanded frameworks—such as the concepts of significant economic presence or virtual Permanent Establishment—to capture economic activity in the digital economy effectively. As a result, current regulations often lag behind the rapidly evolving business models that operate extensively without a tangible local footprint.

The interpretation of representative office activities adds another layer of complexity to Permanent Establishment enforcement in Indonesia. According to Nurkholis Rafsanjani and Ardiansyah (2025), there is disagreement over whether administrative or promotional functions give rise to a PE. While companies often assert that such activities are excluded from PE consideration, tax authorities maintain that they can represent a meaningful economic presence. This divergence illustrates how multinational enterprises

exploit the structuring of office roles and functions to limit PE recognition, creating a gap between formal legal interpretations and the substantive economic realities of their operations.

Further research highlights persistent patterns of Permanent Establishment avoidance in Indonesia. Multinational enterprises frequently exploit limited PE definitions or engage in treaty shopping by establishing entities in countries with advantageous tax treaties (Butarbutar, 2023; Putri et al., 2024). In the digital economy, arrangements that operate without a physical presence continue to pose significant enforcement challenges for tax authorities. Taken together, these cases demonstrate the deliberate strategies companies employ to minimize PE recognition, underscoring the ongoing tension between formal legal compliance and the economic substance of business operations under the Indonesian tax system.

Permanent Establishment avoidance by multinational corporations has a substantial impact on tax revenues in source countries, especially in developing economies such as Indonesia. Such avoidance contributes to base erosion and the shifting of profits to lower-tax jurisdictions (OECD, 2013). Empirical evidence suggests that developing nations experience relatively greater revenue losses from international tax avoidance compared with developed countries (Beer, de Mooij, & Liu, 2020).

In Indonesia, avoidance of Permanent Establishment status reduces corporate income tax revenues from foreign operations, with the services and digital sectors particularly affected (Setiadi & Darussalam, 2019). Beyond the immediate fiscal impact, PE avoidance creates competitive imbalances, as domestic firms face higher tax burdens than multinational corporations (Cobham & Janský, 2018). Over the long term, such practices can undermine overall tax compliance and erode public confidence in the integrity of the tax system (Lang & Reimer, 2021).

Global efforts, such as BEPS Action 7, seek to address artificial Permanent Establishment avoidance by ensuring that profits are taxed in the jurisdictions where economic activity is carried out. Key measures include clarifying and strengthening PE definitions, promoting international collaboration among tax authorities, and adopting a substance-over-form approach. These strategies are essential for reducing the adverse effects of PE avoidance on domestic tax revenues and for supporting a fairer allocation of taxing rights across countries.

Analysis and Discussion

Based on the case studies and empirical evidence discussed in Chapter IV, Permanent Establishment (PE) avoidance in Indonesia is primarily achieved through corporate and contractual arrangements designed to circumvent the requirements of physical presence and economic substance. Multinational corporations frequently exploit gaps in the PE definition, particularly regarding fixed place of business and dependent agent provisions. In practice, foreign companies perform significant economic activities in Indonesia, including marketing, contract negotiation, and operational oversight, yet classify these functions as

preparatory or auxiliary. As a result, these entities are not legally recognized as having a PE, despite generating direct economic benefits from the Indonesian market. It demonstrates a recurring divergence between formal legal form and actual economic substance. Judicial reviews, including tax court and Supreme Court decisions, indicate that PE disputes often hinge on the authority held by representatives and whether activities constitute core business functions rather than merely supportive tasks. Therefore, PE avoidance in Indonesia is generally not considered illegal but functions as a deliberate strategy operating in the grey area between formal compliance and aggressive tax planning.

An assessment of Indonesia's tax regulations shows that its Permanent Establishment (PE) framework generally aligns with international standards as outlined in the OECD Model Tax Convention. The Indonesian Income Tax Law and bilateral tax treaties provide a formal legal basis for taxing foreign business activities within the country. However, these regulations face challenges in addressing contemporary business models and complex multinational structures. The traditional focus on physical presence makes the PE definition less effective in capturing economic activities arising from digital business models and cross-border service operations, leaving some income untaxed. At the international level, OECD initiatives, particularly BEPS Action 7, aim to broaden the definition of PE to prevent artificial avoidance. Although Indonesia has committed to implementing BEPS recommendations, domestic adoption still requires adjustments to regulatory frameworks, tax treaties, and administrative procedures. Therefore, while Indonesia's legal framework aligns with OECD standards in principle, its practical effectiveness in limiting PE avoidance depends on consistent enforcement, thorough economic substance assessments, and the operational capacity of tax authorities.

The enforcement of Permanent Establishment taxation in Indonesia encounters several structural and technical challenges. One major obstacle is the complexity of multinational corporate structures, which often involve multiple entities across different jurisdictions with interrelated functions and risks that are difficult to delineate. This complexity makes it challenging to identify the actual locations of value creation. Information asymmetry between tax authorities and international taxpayers further complicates enforcement, as authorities frequently face difficulties accessing contracts, internal organizational arrangements, and strategic decision-making processes maintained outside Indonesia. Additional challenges arise from the potential for international tax disputes, including risks of double taxation and divergent interpretations across jurisdictions. Determining PE status in Indonesia can be contested by the foreign entity's country of residence, requiring procedures such as the Mutual Agreement Procedure (MAP), which demand significant time and resources. Moreover, limitations in human resources and institutional capacity affect the effectiveness of PE enforcement, as resolving such cases requires specialized knowledge of international tax law, treaties, and complex global business operations, which are not always applied consistently at the audit level.

CONCLUSION

Based on the analysis of Permanent Establishment (PE) avoidance and evasion, several conclusions emerge. First, the PE concept in international tax law functions as a fundamental mechanism for defining the taxing rights of source countries over income generated by foreign taxpayers. The presence of a PE establishes the legal threshold that determines whether a jurisdiction has the authority to tax profits from foreign business activities, as reflected in the OECD and UN Model Tax Conventions and implemented through various Double Taxation Agreements (DTAs).

Second, Permanent Establishment avoidance and evasion are implemented through a range of strategies, including the appointment of deemed independent agents, fragmentation of business operations, limiting or avoiding a permanent physical presence, and leveraging digital business models that operate without a tangible footprint in the source country. Although these practices typically comply with formal legal requirements, they can significantly erode the tax base of the source jurisdiction.

Third, the occurrence of Permanent Establishment avoidance is shaped by several critical factors, including variations in PE regulations across countries, the inadequacy of traditional PE concepts to capture digital economy activities, and information asymmetries and relative bargaining power between tax authorities and multinational corporations. The expansion of digital business models has further amplified opportunities for avoidance, allowing companies to generate substantial income without maintaining a clear physical presence in the source jurisdiction.

Fourth, Indonesia has implemented Permanent Establishment regulations through its domestic Income Tax Law and bilateral tax treaties with partner countries. The country has also begun aligning its tax policies with international developments, incorporating anti-avoidance measures and participating in initiatives such as the BEPS project. Despite these efforts, effectively enforcing and monitoring PE rules remains challenging, particularly in detecting PEs arising from cross-border operations and digital economic activities.

Based on these findings, several recommendations emerge. Policymakers should continue updating PE regulations to address evolving digital business models, including adopting a significant economic presence approach alongside the traditional PE framework. Tax authorities should enhance monitoring and administrative capacity, particularly in evaluating the structures of multinational enterprises that may engage in PE avoidance or evasion. Strengthening international cooperation and information exchange remains essential to close gaps exploited for avoidance. Regular review of Indonesia's DTAs is also necessary to ensure consistency with international standards and to prevent misuse for treaty shopping or aggressive tax planning. Finally, future research should emphasize empirical studies and detailed case

analyses of PE avoidance, especially in the digital economy, to provide practical insights into the effectiveness and impact of current tax policies.

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