Indonesian tax news
Highlight

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Permanent establishment

In-country foreign business eyed

Indonesia can only tax business profits of a foreign enterprise if it carries on business in Indonesia through a permanent establishment (PE) located in Indonesia. This is an international standard enshrined in the Income Tax Law (ITL). Conditions are set in the ITL under which a foreign enterprise's activities in Indonesia will lead to the creation of a PE. These conditions have just been reiterated by MoF Regulation No. 35/PMK.03/2019 (PMK 35) issued on 1 April 2019.

In line with the self-assessment system, the determination of whether a PE exists pursuant to the activities of a foreign enterprise in Indonesia is left to the enterprise concerned. PMK 35 only asserts the requirement to register the PE once it is created with the Indonesian Tax Office (ITO), adding that the Director General of Tax (DGT) may use its *ex-officio* authority to register the PE which fails to do so by itself.

Under international standard, a PE is just a nexus bringing about a taxing right to the country in which the PE is located (host country) over of the business profit of the foreign enterprise to which the PE belongs. How much the host country can tax is another thing. In any case, it should not be more than the business profits attributable to the PE. Hence, a PE, under international standard, does not necessarily entails a tax liability to the host country, e.g. in the case of a loss making PE.

Construction business

Under the ITL, the notion that PE determination and profit attribution to the identified PE is two different things is not always true. Construction business, for instance, is subject to final income tax. As tax is imposed on the gross income at a specified rate (notionally 25% of a deemed profit), the final income tax does not recognize any loss. Hence, a PE engaging in construction business in Indonesia, as long as generating revenues, will automatically be liable to income tax in Indonesia without regard to the expenses incurred.

PMK 35 addresses broadly, among others, construction business in the context of "construction, installation and assembly projects". A construction project of a foreign enterprise, under the ITL, will automatically constitutes a PE. How long the project continues will only count if a tax treaty is in force given that tax treaties typically specify the minimum period (ranging from six to twelve months) for a construction project to qualify as a PE.

PMK 35 provides the way to determine the length of a construction project. It is considered to start from the date when the foreign enterprise commences its business activities (relating to the project) in Indonesia, including the preparatory works, and to end at the completion and delivery of the project or when the project is permanently discontinued (before completion). Intermittent times are included in the project length. If the tax treaty sets the time test in days, a part of a day is counted as one day. If it is in month, a part of a month (e.g. one day) is considered a month. If the foreign enterprise passes the work to a subcontractor, the time spent by the subcontractor is added to the time spent by the original contractor.

A construction project in accordance with PMK 35 includes the following areas:

- *Construction consulting* – covering feasibility study, planning, designing, supervision, construction performance management, surveys, technical tests and analysis;
- *Construction contracting* – including construction building, operation, maintenance dismantling, and rebuilding; and
- *Integrated construction work* – covering designing model or engineering model, procurement, and performance.

An installation and assembly project extends to installation or assembly of (complex) machinery or equipment not necessarily related to a construction project. Such projects as well as construction projects include not only the work done in Indonesia but also that done outside Indonesia by either the original contractor or the subcontractors who continue the original contractor's work.

E-commerce

PMK 35 signals slightly how the DGT will deal with businesses carried on electronically (e-commerce) by foreign enterprises in Indonesia. Apparently constraint by domestic legal provision and taking into account the existing international consensus, it states no more than a normative stance adopted by the OECD Model: maintenance of a fixed place of business by a foreign enterprise in Indonesia merely for data storage or data processing with the enterprise having only limited access to the fixed place of business does not lead to the creation a PE.

The statement may refers to an illustration in the 2017 OECD Model commentary of an enterprise which stores its web site in a server located in foreign country (host country). The web site, being a combination of software and data, does not in itself constitute a tangible asset and accordingly does not have a location qualifying as a fixed place of business. The server, under certain circumstances, may qualify as a fixed place of business. However, if it is operated by another party, e.g. an internet service provider (ISP) as mostly the case, the server will not be at the disposal of the enterprise owning the web site implying the enterprise's limited access to the server.

Despite the rule, the DGT may proceed to deem a PE if the server in which a foreign enterprise store its web site serves beyond mere data storage and data processing and/or the enterprise has broader access to the server than shown by the illustration.

Service-based PE

By default a PE calls for a fixed place of business through which a foreign enterprise carries on business partly or wholly in the country in which the PE is located. Per definition, without a place fixed or business, there should be no PE.

Service-based PE is an exception. When it comes to service furnishing, asserting the ITL provision, PMK 35 states that a foreign enterprise may create a PE in Indonesia if it furnishes services in Indonesia through its personnel for more than 60 days within a twelve-month period. Whether or not the enterprise maintains a fixed place of business to furnish the services does not count in the PE determination.

Preparatory and auxiliary activities

In a tax treaty context, the notion of preparatory and auxiliary activities is generally meant to moderate the scope of the general definition of a PE. It refers to the activities conducted by a foreign enterprise through a fixed base of business in a (host) country without causing the fixed base of business to become a PE of the foreign enterprise in the host country.

Referring to the 2017 OECD Model commentary, a preparatory activity is defined as an activity "that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole". An auxiliary activity refers to the ones "carried on to support, without being part of, the essential and significant part of the enterprise as a whole". The OECD Model does not defines what constitutes an essential and significant part of the business activity acknowledging that this (the core function of a particular enterprise) will depend on the nature of the business carried on by the enterprise.

PMK 35 adopts similar definitions of preparatory and auxiliary activities. Moreover, it puts forward the following criteria for an activity of an essential and significant nature:

- It is the core activity of the foreign enterprise;
- It is inseparable from the core activity of the foreign enterprise; or
- Directly producing income of foreign individual or company;
- It is performed using assets or human resources of a significant size.

PMK 35 states that the moderation of PE definition brought about by preparatory and auxiliary activities applies only when a tax treaty is in force.

How much profits attributed to a PE?

As aforesaid, determining the existence of a PE is dealt with separately in the ITL and in tax treaties from attributing business profits to the identified PE. PMK 35 aims only to reassert the conditions under which a foreign enterprise engaging a business in Indonesia will lead to the creation of a PE. It is apparently by accident that PE creation in construction business automatically entails profits attribution to the PE pursuant to the adoption of final income for the business.

Apart from construction business, the ITL sets its own standard to determine the business profits of a PE. To a certain extent, it is in line with the arm's length principle adopted by international standard such as OECD Model and UN Model tax conventions.

WHT23/26
Upgraded tax compliance system

The DGT stepped up its effort to implement its upgraded WHT23/26 compliance system. Launched in 2017, according to DGT Reg. 04/PJ/2017 (Reg. 04), the system involved only 15 taxpayers at the outset treating it as a pilot project. By the passage of time, possibly with some improvement, more and more taxpayers were called in to participate in the project. The last expansion was done in late April 2019 the inclusion of 1745 taxpayers from the most prominent tax service offices (Large tax office, PMA tax office,

Badora, Go-public company tax office, and certain middle tax offics of Jakarta) as shown in DGT Decree. 425/PJ/2019 of 22 April 2019 (Decree 425).

A few important features of the upgraded system are as follows:

a. Two modes of tax compliance are available: manual (hard copy) and electronic. For the electronic mode, tax compliance is to be carried out using *e-Bupot 23/26*, i.e. the DGT-developed application, available on the DGT website;

b. The manual mode applies only to taxpayers with WHT23/26 slips fewer than 20 pieces a month and the amount of gross income of each WHT slip not exceeding Rp100 million;

c. Once a taxpayer issues more than 20 pieces of WHT23/26 slips a month and the amount of the gross income covered in each slip exceeds Rp100 million, it has to move to the electronic mode. Once it has used the electronic mode, it cannot return to the manual mode;

d. WHT slips are numbered with 10 digits: the first two digits are for the WHT codes (WHT23 or WHT26), the next eight digits are for the serial number. Each year should start a serial number of 00000001. For the manual mode, the taxpayer is responsible for maintaining the sequence of the serial numbers. For the electronic mode, the number is provided automatically by the system (*e-Bupot 23/26);*

e. A WHT slip should bear the identity code of the party being withheld ("withholdee"). For a domestic taxpayer (WHT23), by default it is the witholdee's NPWP. If not available, the witholdee's citizenship number ("NIK") should be used instead. For foreign a withholdees, it should be their tax identity number (TIN);

f. Revisions of WHT returns and WHT slips should follow a strict procedure. A revision of a WHT slip is made if it contains incorrect information. Cancellation only applies if the underlying transaction is cancelled. The existing number of the revised or cancelled WHT slip should be maintained in the revised WHT returns.

g. A WHT slip not yet reported for a tax period (month) can only be revised up to the 20th of the month next to the month of the WHT slip.

h. If a revision of a WHT return results in a tax underpayment, the underpaid tax should be paid before filing the revised WHT return. If it results in an overpayment, a refund may be applied in accordance with refund procedures for "for tax which should have not been due";

i. If relevant, other information needs to be filled out into the WHT slips, e.g. the certificate number and the applicability period of a WHT exemption certificate for WHT23 and the issuance date of the Certificate of Domicile for WHT26.

The new system should arguably enhance the reliability of the WHT slips and thereby improve the DGT's service to taxpayers. It should also encourage taxpayers to prepare WHT slips, pay, and report WHT on time.

Please check to the Attachment of Decree 425 to see if you are covered in the current batch taxpayers required to participate in the upgraded WHT23/26 compliance system.

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