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Digital Taxation in Indonesia

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Key Messages

- With e-commerce transactions on the rise when fiscal pressures were mounting during the Covid-19 crisis, the Indonesian government decided to enact Law No. 2/2020. Among others, it aims to impose income taxes on electronic systems transactions by foreign service providers with 'significant economic presence' which would constitute a permanent establishment in Indonesia.

- When the threshold for 'significant economic presence' is met, these corporations will then be subject to paying corporate income tax in Indonesia. However, challenges remain in determining the proportion of the business profit sourced in Indonesia and how to share the right to tax corporate profits with the authorities of the company's residence abroad.

- The Organisation for Economic Co-operation and Development (OECD) is spearheading an ongoing effort to develop mechanisms to tax business profits between source and recipient countries. For many, the process has taken longer than expected and has triggered several countries such as India and Indonesia to come up with a unilateral proposal called the 'electronic transaction tax'. While this type of tax has not been implemented by the Indonesia government, multilateral consultation needs to continue in order to arrive at a mutually-agreed international tax framework.

- The Indonesian government also levied a value-added tax (VAT) on the provision of intangible goods or services in Indonesia. Ministry of Finance (MOF) Regulation No. 48/2020 set the rate at 10%, effective on 1 July 2020. Some of the prominent foreign electronic system providers have been appointed as VAT Collectors and have been collecting, remitting and reporting VAT for the goods and services consumed by Indonesian users.

- VAT obligations require a well-functioning system to collect, report and submit VAT. Otherwise, Indonesia might share the experience of the EU, which struggles with low levels of compliance and a lack of enforcement. MOF Regulation No. 48/2020 does not determine a dispute settlement procedure in cases of non-compliance. It still maintains previous procedures for conventional tax disputes with penalties that hardly apply to the digital economy.
- GR 80/2019 and its implementing Trade Ministerial Regulation No. 50/2020 prescribe a requirement for foreign e-commerce providers (PPMSE) to set up a trade representative office in Indonesia. However, the outlined threshold of a minimum of 1,000 transactions per year does not match the criteria outlined in Law 2/2020, which are based on the sales amount and not the number of transactions.

Regulating Indonesia's Digital Economy


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Indonesia's digital economy has reached an impressive size. In 2020, its Gross Merchandise Value (GMV), which measures the value of transactions or sales, was expected to reach USD 44 billion. Indonesia contributed almost half of the total GMV to the internet economy in Southeast Asia. Most of the Indonesian GMV was generated in e-commerce services (USD 32 billion), followed by transportation & food platforms (USD 5 billion), online media (USD 4.4 billion), and online travel (USD 3 billion) (Google, Temasek, and Bain & Company, 2020).

The growth of the digital economy saw the emergence of several Indonesian "unicorns", which are digital start-ups with a market capitalization of more than USD 1 billion, but also a significant presence of foreign operators. Since online businesses have distinctly different characteristics than traditional and offline "brick-and-mortar" businesses, the Indonesian government introduced a range of new rules to regulate online marketplaces.

Government Regulation No. 71 of 2019 on the Implementation of Electronic Systems and Transactions (GR 71) provided a definition of private Electronic System Operators (ESOs). It identified them in broad terms as those with an online portal or application to provide, manage, operate, trade or offer goods and services, financial transaction services, delivery of electronic mail and other digital material and content, communication services in the form of short messages, voice calls, emails, chats and social media services, as well as search engines for electronic information in the form of text, sound, picture, movies, games etc (Baker McKenzie, 2019).

According to Ministry of Communications and Informatics (MOCI) Regulation No. 5/ 2020, all private ESOs have to register with MOCI. Private ESOs offer Over The Top (OTT) services, which basically means their services go over the top of an existing Internet Protocol (IP)-based telecommunications network. MOCI Circular No. 3 of 2016 on the Provision of Content and/or Application Services over the Internet regards OTT transactions as those providing applications and content services. Following a rather broad definition in further regulatory drafts, "applications" are those allowing for the use of a telecommunications service in the form of text messages, voice calls, and online conversations, financial and commercial transactions, storage and retrieval of data, games, networking and social media, and their respective derivatives. "Content" is provided in the form of any digital information that is streamed or downloaded, including text, sound, images, animations, music, videos, movies, games, or a combination of any such digital information.

These regulations provided a regulatory framework for the operations of the digital economy, but when the Covid-19 pandemic started the government also put an eye on the fiscal potential of the ever-growing digital markets.

New technologies have enabled companies to reach and deliver services to users outside their host countries. This is also the case in Indonesia, where foreign digital service providers have a strong market presence, some without maintaining a physical establishment. Domestic authorities generally struggle to regulate this cross-border trade and they are further challenged by the fact that digital goods and services are purchased from outside the jurisdiction of the country where the customer resides. Without a domestic establishment of the foreign provider, local tax authorities encounter problems in defining the tax base - due to differing international tax regimes - and enforcing the timely and accurate submission of taxes.

Once the pandemic started in 2020, the Ministry of Finance (MOF) faced the tremendous task of covering the costs of the Indonesian National Economic Recovery Program (PEN) amounting to IDR 579.8 trillion (USD 42 billion). Originally the government had budgeted IDR 695 trillion, which would have been 40% of all central government expenditures in 2020. In 2021, the Minister signalled to the media that a similar amount might be needed again (Kontan, 2021) leading to a state budget deficit of 5.5% over Gross Domestic Product (GDP) (MOF, 2020b).

Since Indonesia's tax-to-GDP ratio stands a few percentage points below those of neighbouring countries like Malaysia, Singapore or China, there appears to be room for broadening the tax base to increase the country's tax revenues. Following that rationale, the Indonesian government decided to start taxing intangible products offered by foreign digital service providers to support the National Economic Recovery Program.

On 16 May 2020, Law No. 2/2020 on State Financial Policy & Financial System Stability imposed taxes on OTT electronic transactions. These taxes are applied to foreign service providers and foreign traders that operate through an electronic system or *Perdagangan Melalui Sistem Elektronik* (PMSE) and they also apply to those that cannot be designated as a permanent establishment or *Bentuk Usaha Tetap* (BUT) (KPMG, 2020).

Taxes include both, a direct corporate income tax imposed on the income of foreign service providers as well as an indirect Value-Added Tax (VAT) levied on the consumption of OTT electronic transactions in Indonesia.

Moreover, since 2017, the Indonesian government has also been involved in international discussions about custom duties on the import of intangible digital products. In accordance with a World Trade Organization (WTO) moratorium, MOF Regulation No. 17/2018 has set zero customs duties on the import of these products. However, Indonesia argues that the moratorium only applies to electronic transmissions and not to products which are submitted electronically. It is seeking agreement to charge customs duties on the import of intangible digital products (Buditomo, R 2018; ICC, 2019).

Corporate Income Tax (CIT) on Revenues of Foreign Providers of Digital Services with Significant Economic Presence in Indonesia

Policymakers in several countries are planning to tax the income of a company with significant economic presence but without a physical permanent establishment. By September 2020, 22 countries have been applying such direct taxes in their digital economy, while 16 others considered introducing such taxes (Sukardi, & She, 2020).

Indonesian Law No. 2/2020 adopted this new approach and responded to the situation that foreign digital companies enjoy a significant market presence in Indonesia. According to media reports, the streaming service *Netflix*, for example, was predicted to reach 907,000 Indonesian subscribers in 2020 (Katadata, 2020) It was further reported that users of the online meeting platform Zoom increased by 183% during just the first three weeks of the pandemic in March 2020 (Bisnis.com, 2020) It is safe to assume that subscribers kept increasing throughout the entire period of social distancing measures.

In the digital economy, companies can generate profits made from electronic transactions in destination countries and shift these profits to the jurisdiction where they are resident. While this may be considered unfair in destination countries, this is a legitimate practice based on the existing international tax framework, also known as Base Erosion and Profit Shifting (BEPS). It is the subject of current reforms spearheaded by the OECD. An ongoing debate in the OECD addresses this practice and tries to establish how the relative shares of corporate costs and revenues can be attributed to both, the country of origin and to activities in the destination state (Turina, 2018).

Law No. 2/2020 regulates that companies which are not registered in Indonesia can be taxed for their income in Indonesia. If an existing tax treaty prevents charging a corporate income tax, Law No.2/2020 imposes an Electronic Transaction Tax (ETT) on direct sales or sales through the marketplace (Sukardi, & She, 2020).

For companies that are considered to maintain a significant presence in Indonesia's economy, a portion of their corporate income taxes, which would otherwise be due in the company's home jurisdiction, will be attributed to the authorities in Indonesia, where the products and services went to market. According to Government Regulation (GR) No. 80/2019, a company is deemed to have a significant presence in Indonesia, if it passes certain thresholds defined by the number of transactions, the transaction value, the number of shipping packages, and the amount of traffic or platform access (EY, 2020) Law No. 2/2020 defines this physical presence as a Permanent Establishment (PE) and makes those companies liable to paying Corporate Income Tax (CIT).

There seemed to be an inconsistency between GR 80/2019 and Law 2/2020 which may cause uncertainty in the market. Law 2/2020 does not make the physical presence a requirement for foreign e-commerce providers (PPMSE) to be taxed in Indonesia, while GR 80/2019 and its implementing Trade Ministerial Regulation No. 50/2020 prescribes a requirement for foreign PPMSE to set up a trade representative office (KP3A) in Indonesia. It outlined a threshold of a minimum of 1,000 transactions per year, which does not align with the criteria outlined in Law 2/2020 based on the sales amount and not the number of transactions. There also appears a lack of alignment between relevant authorities, since taxation criteria typically fall under the purview of the MOF.

The new tax regime affects tax revenues of the home jurisdictions of foreign companies. Their governments will disagree, especially if they find this unilateral action in violation of specific tax treaties and agreements with Indonesia. Indonesia is party to 33 double-taxation agreements with other countries (OECD, 2019a) Unilaterally mandating corporate income taxes on digital goods and services can contradict principles of these double taxation agreements.

This is a particular concern of the government of the United States, which is home to the biggest technology companies that sell their digital goods and services in Indonesia. The Office of the United State Trade Representative (USTR) issued a document in January 2021 called the "Section 301 Investigations Status Update On Digital Services Tax Investigations of Brazil, the Czech Republic, the EU and Indonesia". The U.S. government launched its investigation out of concerns that the unilateral imposition of income taxes and ETT by Indonesia and other countries create a special and unfavourable tax treatment of U.S. companies. This could result in the suspension of certain trade concessions by the U.S. or to the imposition of duties on goods from Indonesia. The U.S. government might also consider bringing this matter up for dispute resolution at the WTO (Adiyanto, 2021).

In its efforts to find international consensus on challenges caused by BEPS, the OECD is currently facilitating a discussion of models and methods of profit sharing in Pillar 1 BEPS of its negotiations. This pillar applies the concept of net taxation of income, avoids double taxation and aims to be as simple and administrable as possible (OECD, 2020) It has inspired the Indonesian government to adopt the new concept of "*significant economic presence*" and to broaden the concept of a permanent physical establishment by adding a digital permanent establishment in the online economy.

Yet, unilateral actions to impose direct taxes on digital products and services by foreign providers can lead to disputes, especially with countries with double taxation treaties with Indonesia. Moreover, compliance costs and tax rate adjustments for smaller economies also need to be addressed (OECD, 2020).

Due to these considerations, MOF has suspended the imposition of these taxes until a multilateral solution has been identified. However, while corporate income taxes still await agreement within the OECD framework, the government of Indonesia has proceeded with collecting value-added tax on intangible foreign goods and services.

Indonesian Value-Added Tax (VAT) on Intangible Foreign Goods and Services

When an indirect consumption tax is charged in a specific country on the value added to digital goods and services at the time of their purchase, it does not affect foreign tax jurisdictions. A value-added tax (VAT) is therefore being levied by more countries than corporate income taxes on digital goods and services. 75 countries were implementing such taxes in September 2020 and eight other countries were in the process of drafting such legislation (Sukardi, & She, 2020).

Law No. 2/2020 served as the umbrella regulation for the introduction of VAT on intangible goods and services from outside Indonesia's customs territory that are traded through electronic systems (Perdagangan Melalui Sistem Elektronik – PMSE). MOF Regulation No. 48/2020 provided guidelines for implementing the VAT collection (MOF, 2020a). Commencing in July 2020, sales of these products and services were taxed at the rate of 10%, which is higher than the rates in neighbouring Malaysia (6%) and Singapore (7%).

Subject to the new VAT regulation are digital goods, like software, multimedia and electronic data (apps, games, music, film, ebooks), as well as digital services providing the aforesaid products as well as web hosting, video conferencing and other services (Nugroho, & Tampubolon, 2020).

MOF Regulation No. 48/2020 stipulates in Article 2 (2) that VAT shall be collected, remitted and filed by any individual or entity that carries out e-commerce business activities. If intangible taxable good and services from outside of the customs and excises territory are traded within this territory through e-commerce, then individuals or entities will be appointed by MOF as VAT collectors.

Only minor sales will be excluded from VAT. According to Regulation No. 12/2020 by the MOF Directorate General of Taxes (DGT), businesses will be appointed as VAT collectors if the transaction value with their customers in Indonesia exceed IDR 600 million (USD 42,000) in a year or IDR 50 million (USD 3,500) in a month, or if 12,000 users visit their e-commerce platform from Indonesia in 12 months, or one thousand users in one month (Sukardi, & She, 2020).

The appointed VAT collector must report the VAT collections quarterly through a report that consists of the total number of recipients, the amount charged to recipients (without VAT), the amount of tax collected, and the amount of tax remitted. Sales are taxable and need to be reported if payments used debit, credit or other payment facilities provided by an institution in Indonesia, if they used an internet protocol address in Indonesia or a phone number with an Indonesian country code.

Problems with the accurate assessment, reporting and remittance of VAT on intangible goods and services emanate from the complexities of the digital economy. The OECD has been studying the efficient and effective collection of VAT. It considers regimes of full VAT liability like in Indonesia, where the digital platforms are fully and solely liable for collecting and submitting VAT in the correct amount. The OECD compares them to alternatives that may increase compliance regarding these goods and services as well as their supplies (OECD, 2019b). In fact, the European Unition appears to be facing low compliance of non-EU taxable persons and struggles with high compliance costs and an ineffective enforcement strategy (Hidayat, 2020). Determining a customer's location is another problem. The New Zealand government ruled that customers in New Zealand can be fined up to NZ $25,000 if they make use of VPN services and pretend they are in another jurisdiction to avoid paying the general sales tax on digital goods and services.

Despite existing challenges, by the end of 2020, 51 VAT collectors had been appointed by MOF. These included local companies, like Tokopedia, Bukalapak, Blibli and Shopee and a majority of large, foreign-based VAT collectors, including Microsoft, Alibaba Cloud, IBM, Amazon, Google, Netflix, Spotify, Skype, Linkedin and Twitter.

Further Changes to the Tax Code are Needed to Integrate the Digital Taxation Regime in Indonesia

Policy challenges continue to exist regarding the collection of VAT on digital goods and services. The Law of Administrative Guidelines of Indonesian Taxation (Law No. 28/2007), for instance, does not see companies as responsible parties for tax collection in Indonesia. This will matter in future compliance cases. Tax liabilities need to be acknowledged by the law if non-compliant actors are to be sanctioned. Administrative taxation guidelines need to be revised and determine the role of VAT collectors.

Indonesian taxation policy generally maintains a conventional tax dispute settlement mechanism that is hard to apply in the context of the digital economy. Law No. 2/2020 states that penalties for non–compliant VAT collectors includes cutting off operational access by MOCI, but there are no further regulations regarding the implementation of these provisions by MOF. This issue needs to be addressed in order to provide legal certainty for the involved parties.

Setting up an inclusive and effective dispute settlement mechanism requires a meaningful public-private dialogue with a broad representation of stakeholders. This helps providing legal certainty for tax subjects and VAT collectors. The process helps to build trust and bridges gaps between MOF and business actors. It also helps MOF to adapt to the ever-changing landscape of digital business models and to identify suitable responses to rapidly evolving markets.

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