UNILATERAL DIGITAL INCOME TAXATION BASED ON SIGNIFICANT ECONOMIC PRESENCE: AFFIRMING INDONESIA'S FISCAL SOVEREIGNTY IN THE DIGITAL ECONOMY ERA

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Abstract

This study examines the choice of income tax instruments for the digital economy and develops a unilateral digital income tax framework grounded in the concept of Significant Economic Presence (SEP) for Indonesia, set against the prolonged impasse of the OECD/G20 Pillar One multilateral solution. Employing a qualitative juridical-normative approach and a literature study, it compares an SEP-based income tax with the Electronic Transaction Tax (PTE) through three lenses: fairness, consistency with international tax norms, and the strengthening of fiscal sovereignty. The analysis finds that SEP is normatively superior because it taxes profit in accordance with the ability-to-pay principle and aligns with the doctrine of economic allegiance, yet it is constrained in formal enforceability because it collides with the permanent establishment definition embedded in tax treaties. The PTE, by contrast, is easier to administer but is prone to being deemed discriminatory and to provoking retaliation. The study therefore proposes mitigating measures comprising a high revenue threshold and a non-discrimination principle, a phased implementation roadmap inspired by the CBAM transition mechanism, and institutional and fiscal-diplomacy strengthening. Its principal contribution is an integrated unilateral framework linking nexus design, treaty-conflict mitigation, and implementation strategy.

Keywords: *Digital Tax, Fiscal Sovereignty, Significant Economic Presence, Unilateral Policy, Digital Economy*

1. INTRODUCTION

Advances in information technology have reshaped global commerce and positioned Indonesia as one of Southeast Asia's most dynamic digital markets. The *e-Conomy SEA 2024* report estimates that the gross merchandise value (GMV) of Indonesia's digital economy reached approximately USD 90 billion in 2024, a 13 percent increase over the previous year, with e-commerce contributing around USD 65 billion (Google, Temasek, & Bain & Company, 2024). Data from Bank Indonesia confirm the same trajectory, recording a surge in the value of national e-commerce transactions from IDR 205.5 trillion in 2019 to IDR 487.01 trillion in 2024, with a projected IDR 503 trillion in 2025 (Bank Indonesia, 2025). This rapid expansion has been driven by shifting consumer behaviour, the maturation of payment systems, the proliferation of social commerce, and improvements in logistics. Beneath these encouraging figures, however, lies an unresolved problem, namely how a state can tax the economic value generated within its jurisdiction when that activity takes place without any physical presence.

The most intricate aspect concerns the corporate income tax owed by multinational digital enterprises. Technology giants such as Google, Amazon, and Meta derive substantial income from users in Indonesia, yet they generally maintain no permanent establishment (PE) within the country and are therefore difficult to reach under the prevailing international tax regime. The case of Google, which operates through a representative office of its Singapore-based entity, illustrates how corporate structures and transfer pricing practices are leveraged to shift profits out of the market jurisdiction (Suryani, Utari, & Ariana, 2018). This difficulty is by no means peculiar to

Indonesia; it is a global challenge that has given rise to a series of international tax reform initiatives coordinated by the OECD and the G20 (OECD, 2015).

The scale of the untapped tax base can be inferred from the performance of the Value-Added Tax (VAT) levied on Trade Through Electronic Systems (PMSE). Since its introduction in July 2020, VAT collection from this scheme has grown steadily into the tens of trillions of rupiah (DGT, 2025). VAT, to be sure, is a levy on consumption rather than on profit, so its figures cannot be translated directly into income tax potential. Even so, the sheer size of the digital consumption base strongly suggests that high-value economic activity is taking place that, under an appropriate instrument, ought to contribute to income tax revenue as well. The core problem, accordingly, is not the absence of economic substance but the absence of an adequate legal nexus through which to reach it.

The root of the difficulty lies in the obsolescence of a legal framework that makes physical presence a precondition for taxing rights. The "no PE, no tax" principle, long the backbone of cross-border taxation, loses its footing once corporations are able to extract profit from a market without any office, warehouse, or branch (Alvionita, 2023; OECD, 2018). It is worth recalling that the physical PE threshold is not a foundational principle but an administrative compromise that emerged later. As early as 1923, a report by four economists for the League of Nations articulated the doctrine of economic allegiance, which recognises the taxing claim of the state where wealth is produced and consumed, not merely the state where its owner resides (Bruins, Einaudi, Seligman, & Stamp, 1923). Under the benefit principle, active business income ought to be taxed primarily in the source jurisdiction that supplies the market, infrastructure, and legal protection without which such profit could not arise (Avi-Yonah, 2007). Correcting the physical-presence rule, therefore, is not a radical departure from tradition but an effort to restore taxation to its conceptual roots.

It is from this need that the idea of Significant Economic Presence (SEP) has developed, serving as a new nexus that ties taxing rights to a substantial economic footprint measured through indicators such as revenue derived from the market, the number of active users, and transaction volume (Hongler & Pistone, 2015; OECD, 2015). A comparable idea has since permeated the multilateral arena, notably through Article 12B of the United Nations Model Tax Convention, which grants the source state the right to tax income from automated digital services (United Nations, 2021), as well as in the wider debate on reallocating profit on the basis of value creation (Schön, 2018; Devereux et al., 2021). SEP thus rests on firm conceptual ground, anchoring the tax obligation in economic substance rather than in the formality of physical presence.

The urgency of acting is heightened by the faltering pace of global reform. Pillar One of the OECD/G20 Inclusive Framework, designed to reallocate taxing rights to market jurisdictions, has yet to reach a settlement, obstructed by a number of unresolved technical issues including Amount B (Chaisse & Mosquera, 2022; Kurniati, 2024; EY, 2025). The moratorium on unilateral digital taxes that was once agreed had been tied to the successful finalisation of Pillar One (OECD, 2021); as that consensus fails to materialise, the basis for states to keep exercising restraint correspondingly weakens. For a country with a digital market as large as Indonesia's, waiting for a global consensus is hardly a sensible option. At this juncture the question shifts from the mere optimisation of revenue to a more fundamental dimension, namely fiscal sovereignty as the right of a state to design and enforce its own tax system (Cahyadini, Hutagalung, & Muttaqin, 2023).

This fiscal sovereignty is interwoven with a demand for fairness, that is, the creation of a level playing field between compliant domestic businesses and global corporations that exploit regulatory gaps (Tang, 2024). The question is not whether the state is entitled to tax, but which instrument is both legitimate and robust. Under international law, taxation requires a genuine link between the object of taxation and the levying jurisdiction, and a significant economic presence precisely satisfies that requirement of connection (Hongler & Pistone, 2015). Even so, the

authority to impose a tax does not automatically guarantee its compatibility with Indonesia's commitments under the WTO framework or its network of tax treaties (Perjanjian Penghindaran Pajak Berganda, P3B), a matter that remains contested (Elisabet & Dewi, 2021). A unilateral measure is therefore better understood as a legitimate interim step taken within the bounds of sovereignty while awaiting a multilateral settlement, rather than as a defiance of the international order.

The practice of several countries offers both a model and a warning. The United Kingdom, France, and Spain were among the first to adopt a Digital Services Tax (DST) unilaterally amid the multilateral impasse (Hanrahan, 2021; Enache, 2025). Yet turnover-based levies that are frequently judged discriminatory have proved vulnerable to investigations and threats of trade retaliation from the corporations' home states, and in some instances have had to be suspended or withdrawn under pressure (ITIF, 2025; Igbinenikaro & Adewusi, 2024). The most important lesson is not an invitation to imitate the DST, but the recognition that the durability of a unilateral policy depends heavily on its design. A non-discriminatory, profit-based instrument stands to be far more resilient than a crude turnover-based levy. Within this frame, Indonesia's early success in collecting VAT on PMSE provides a foundation for cautiously extending digital tax policy into the realm of income tax.

Prior studies have examined this issue from various angles while leaving important ground unaddressed. Rizqiyanto et al. (2025) trace the limitations of domestic tax law in reaching cross-border digital activity and recommend SEP as a replacement for the PE concept, yet their discussion stops at the normative level without specifying an operational policy design. Sidik (2022) underscores the importance of global cooperation and cautions against Indonesia's unilateral adoption of a DST, a caution that is pertinent but warrants reconsideration in light of Pillar One's protracted stalemate. Ardin (2021) proposes SEP for the taxation of digital advertising, although the scope is confined to a single sector. Meanwhile, part of the national policy literature has discussed SEP and revived the discourse on the PTE (Astuti, 2024; Rahmawati & Nurcahyani, 2024) without weaving these strands into a coherent whole. It is here that the gap addressed by this study lies, namely the absence of a framework that integrates three elements at once: the design of the SEP nexus, a strategy for mitigating treaty conflict and retaliation risk, and a phased implementation roadmap. These have hitherto been treated separately, even though it is precisely their integration that determines whether a unilateral policy can function.

Building on the foregoing, this study aims to analyse the landscape of unilateral digital tax policy and to formulate an SEP-based digital income tax framework that is adaptive, principled, and workable in the Indonesian context. The problem is addressed through three interlocking steps: determining the most appropriate taxing instrument by weighing the trade-offs between SEP and PTE, designing a policy that mitigates the risks of trade retaliation and treaty conflict, and devising a phased implementation roadmap. Through this framework, the study seeks not merely to assert fiscal sovereignty in normative terms but to offer a realistic path toward realising it amid an uncertain global order.

2. RESEARCH METHOD

This study adopts a qualitative approach combining a literature study (desk research) with a juridical-normative method. The choice rests on the nature of the problem, which is conceptual and policy-oriented and thus calls for an examination of the prevailing legal framework alongside an appraisal of the fiscal policy alternatives available to Indonesia in confronting the digital economy.

The data are secondary, comprising primary and secondary legal materials. The primary legal materials include the relevant legislation, principally the Income Tax Law and Law No. 2 of

2020 (Republic of Indonesia, 2020), as well as policy documents issued by international bodies such as the OECD and the United Nations. The secondary legal materials encompass reputable national and international journal articles, books, policy reports, and publications of independent research institutions, retrieved from databases such as Scopus and Sinta in order to safeguard the quality and relevance of the analysis.

The analysis proceeds in three stages. The interpretive stage construes legal and policy texts to grasp their meaning and implications. The comparative stage juxtaposes the concepts of PE and SEP, weighs the difference between a profit-based unilateral approach and a turnover-based PTE, and examines the practice of other countries as a source of lessons. The synthesis stage assembles the findings into a coherent argument that forms the basis for formulating the policy framework. The comparison of instruments in this study rests specifically on three criteria: fairness, consistency with international tax norms, and the strengthening of fiscal sovereignty.

As a normative study based on secondary data, this research carries an inherent limitation in that it does not incorporate primary data from stakeholders such as the tax authority and digital business actors. Its findings are therefore prescriptive and conceptual in character and remain open to further empirical testing.

3. RESULTS AND DISCUSSION

The growth of the digital economy has exposed the limitations of an Indonesian tax system still anchored in physical presence. As transactions increasingly take place virtually, the territorial principle of taxation becomes ever harder to sustain, and the challenge reaches the most fundamental of concerns, namely fiscal sovereignty. The discussion that follows addresses three matters in sequence, that is, the selection of the appropriate instrument, the design that mitigates its risks, and its implementation roadmap, before closing with the institutional prerequisites that allow the framework to operate.

a) Selecting the Appropriate Policy Instrument

The first step in devising a unilateral digital income tax policy is to determine the instrument best suited to the character of the national tax system. Law No. 2 of 2020 opens two avenues: the imposition of income tax on foreign tax subjects that meet the SEP criteria, or the imposition of the PTE (Republic of Indonesia, 2020). The choice between them is not a merely administrative matter but one that bears on tax fairness, efficiency, and international political and economic implications.

An SEP-based income tax integrates digital activity into the existing income tax regime. In principle, a foreign entity that reaps substantial economic benefit from the Indonesian market is treated as a *de facto* PE, so that the net profit reasonably attributable to Indonesia may be subjected to corporate income tax. Its strength lies in its normative consistency with the principle of taxing profit according to ability to pay, and in the prospect of a foreign tax credit in the residence state, which narrows the risk of double taxation (Avi-Yonah, 2007). Its weaknesses are equally real, chiefly the complexity of allocating profit across jurisdictions, which demands an analysis of functions, assets, and risks (FAR) and considerable technical capacity on the part of the tax authority, and which is consequently prone to transfer pricing disputes (Devereux et al., 2021).

The PTE, which is substantively akin to a DST, is a turnover-based levy imposed at a low rate, typically 2 to 3 percent, on the gross income from certain digital services (Sievering, 2022). The instrument has been employed by several countries, such as France and the United Kingdom (Klein, Ludwig, & Spengel, 2022). Its appeal lies in its simplicity and speed, since its computation does not require cross-border profit allocation. It nonetheless disregards profitability, thereby burdening thin-margin firms disproportionately; it is frequently non-creditable, thus risking double taxation; and it is often regarded as discriminatory by the home states of technology corporations,

such as the United States, which respond with threats of retaliation (MUC Consulting, 2021; Igbinenikaro & Adewusi, 2024). A comparison of the two instruments is summarised in Table 1.

Table 1. Summary Comparison of Unilateral Digital Tax Models

Feature	SEP-Based Income Tax (Profit-Based)	PTE / DST (Turnover-Based)
Tax Base	Net profit attributable to Indonesia	Gross income (turnover) from certain digital services
Administrative Complexity	Very high (requires a profit-allocation mechanism)	Low (mere identification of turnover)
Risk of Double Taxation	Lower (a foreign tax credit may be available)	Very high (generally non-creditable)
Risk of Trade Retaliation	Moderate (more consistent with international income tax principles)	High (frequently deemed discriminatory by home states)
Fairness	Fairer (accounts for the level of profitability)	Less fair (burdens low-margin firms)
Legal Basis in Indonesia	Law No. 2 of 2020 (requires implementing regulation)	Law No. 2 of 2020 as an alternative (fallback) option

Source: compiled by the author (2025).

This choice essentially reflects a policy trilemma, in which the policymaker must balance three competing objectives: administrative simplicity, principled fairness aligned with international norms, and the optimisation of revenue together with the strengthening of fiscal sovereignty. The PTE tends to privilege simplicity and short-term revenue at the expense of fairness and international consistency, whereas SEP emphasises fairness and global alignment but demands a far higher administrative capacity.

It is here that the claim that SEP is "more legitimate" must be disaggregated lest it mislead. The superiority of SEP is normative, in that it is fairer and more consistent with international tax principles. At the level of formal enforceability, however, precisely because SEP taxes business profit, it collides directly with the PE definition and the business-profits provisions of tax treaties, so that against residents of treaty-partner states Indonesia's taxing right may be blocked (Republic of Indonesia, 2020; Cahyadini et al., 2023). It is no coincidence that Law No. 2 of 2020 positions the PTE as the fallback where treatment as a PE cannot be applied because of treaty obligations. In other words, in terms of formal enforceability the PTE is in fact easier, having been deliberately designed to fall outside the scope of tax treaties, whereas SEP is more principled but more constrained. The genuine challenge, consequently, is not to choose the easiest instrument but to design an SEP scheme capable of overcoming the treaty constraint. It is on this justification that the present study rests in still recommending SEP, not because it is free of obstacles, but because it builds the foundation of a tax regime that is sturdier and more competitive in the long run. The complexity that attends it should be answered by building capacity and strengthening implementing regulations, not by evasion.

b) Designing the Policy to Mitigate Risk

Once SEP is established as the principal instrument, the next step is to craft the policy carefully so as to temper two risks, namely trade retaliation, particularly through a review by the United States Trade Representative (USTR), and conflict with the applicable tax treaty provisions. A careful formulation grounded in international practice has been shown to narrow the scope for criticism while reinforcing the policy's legitimacy (Elisabet & Dewi, 2021).

The experience of France and the United Kingdom shows that setting a high threshold is one effective mitigation strategy. Indonesia could pursue a similar path by establishing a large global revenue threshold, for instance one aligned with the EUR 750 million country-by-country reporting threshold also used within the Pillar Two framework, combined with a proportionate domestic revenue threshold (OECD, 2021). A high threshold ensures that only large-scale digital entities, those that genuinely contribute to base erosion, fall within the obligation, while also rebutting allegations of discrimination, since small businesses and start-ups are left unburdened.

The insistence that the tax object is the net profit reasonably attributable to Indonesia, rather than turnover, constitutes the principal point of distinction from a DST and, at the same time, the argument that the policy accords with international tax principles. The greatest challenge lies in the methodology of profit allocation. For the initial stage, Indonesia could adopt a simplified formulary approach in certain sectors, for example on the basis of the proportion of sales or of users in Indonesia relative to the global total, before moving to the more intricate FAR method as the authority's capacity matures (Devereux et al., 2021). The policy must, in addition, be formulated as nationality-neutral and non-discriminatory, so that every entity meeting the SEP criteria and the threshold is subject to the same rules regardless of its country of origin. This non-discrimination principle simultaneously narrows the ground on which other states might accuse Indonesia of targeting corporations from a particular jurisdiction.

The potential conflict with tax treaties must be anticipated along two tracks. The first is a dynamic interpretation, advancing the argument that intensive and sustained digital engagement with the Indonesian economy may be regarded as a new form of carrying on a business that constitutes a kind of virtual PE (Cahyadini et al., 2023; Hongler & Pistone, 2015). This interpretation is admittedly contestable, since it departs from a literal reading of treaties drafted in the pre-digital era, yet it has a strong conceptual basis given the transformation of business models over the past two decades. The second, longer-term track is the proactive renegotiation of tax treaties with the principal partner states in which digital entities are resident, so that significant economic presence is explicitly recognised as a basis for taxation. This step confers legal certainty while reducing bilateral friction and reinforcing Indonesia's position in the global architecture of digital taxation.

c) A Phased Implementation Roadmap

Implementing an SEP-based income tax demands a strategy that is adaptive to institutional, technical, and geopolitical challenges, which makes a phased approach the sensible choice. Inspiration may be drawn from the transition mechanism of the European Union's Carbon Border Adjustment Mechanism (CBAM), which separates a reporting phase from a financial-obligation phase in order to allow room for adaptation (European Commission, 2024). It should be stressed that the analogy is confined to the transition design rather than the substance, for CBAM is a carbon adjustment on imported goods, whereas the present policy concerns an income tax on digital services.

The first phase is a transitional period of mandatory reporting lasting two to three years. Foreign digital entities expected to meet the SEP criteria would be required to register and report their economic activity, including revenue from Indonesian users, the number of active users, and transaction volume, without any obligation to pay income tax at the outset. This period familiarises business actors with the reporting system, affords the Directorate General of Taxes (DGT) time to build its data-collection and analysis systems, and allows the refinement of implementing regulations governing the SEP threshold and the profit-allocation methodology. On the diplomatic front, this phase signals to trading partners that Indonesia is preparing rather than levying aggressively at once, thereby lowering the temperature of potential bilateral tension.

The second phase is the partial imposition of the obligation. Once the systems and legal framework have matured, the payment obligation is introduced through a gradual phase-in, for instance beginning with a small share of the income tax due and rising year by year toward the full amount. This mechanism affords the business community room to adjust, gives the DGT time to refine its oversight, and begins to generate revenue without an abrupt shock.

The third phase is full application. All provisions are applied in their entirety, with a DGT that by then possesses the information systems, human resources, and legal instruments adequate to administer reporting, auditing, and dispute resolution. Periodic evaluation drawing on data from the two preceding phases is key to keeping the policy relevant.

The phased approach offers several advantages. It allows time for adjustment and thus tempers administrative and political risk, it opens space for learning grounded in real data rather than assumption, and it permits the construction of a credible digital tax regime without stifling the growth of the digital economy itself. To be optimal, this roadmap needs to be communicated openly, furnished with performance indicators at each phase, and evaluated regularly.

d) Strengthening the Ecosystem and Supporting Institutions

A phased roadmap will succeed only if it is underpinned by institutional readiness. Without adequate support, the transitional reporting system and the gradual obligation risk breeding confusion and uneven compliance. Implementation must therefore be accompanied by the strengthening of institutional capacity, the integration of tax technology, and cross-sectoral coordination.

The first area of strengthening lies within the DGT itself. Investment in the core tax administration system and in big-data processing is foundational, yet not sufficient. The DGT needs to establish a dedicated functional unit conversant with the digital economy, cross-border transactions, and the principles of international taxation, supported by continuous training in digital business models, the detection of avoidance schemes, and profit-allocation methodologies.

The second area of strengthening calls for inter-ministerial coordination within a whole-of-government framework. The challenge of digital taxation cannot be handled by the Ministry of Finance alone. A standing task force is required, involving the Ministry of Finance as designer and implementer, the ministry responsible for communications and digital affairs as a provider of data and platform regulation, the Ministry of Foreign Affairs as the steward of diplomacy and treaty negotiation, and the Ministry of Trade as the manager of retaliation risk. Absent close coordination, the government's response will be fragmented and sluggish.

The third area of strengthening is the construction of a reliable data infrastructure for monitoring digital economic activity in real time. The integration of data across institutions, including from Bank Indonesia and the investment authority, reinforces traceability and the accuracy of tax allocation, while also serving as the evidentiary basis for the policy's legitimacy.

On the global stage, Indonesia's economic diplomacy must be proactive. The government needs to build a narrative within the OECD, the G20, and the United Nations that an SEP-based income tax is neither protectionism nor discrimination but an adjustment of the tax system to the reality of value creation in the digital era (OECD, 2018; United Nations, 2021). A consistent narrative grounded in legal argument will defuse potential conflict before it escalates into retaliation.

Ultimately, long-term success hinges on the voluntary compliance of business actors. Taxpayer education, clear reporting guidance, online consultation services, and a user-friendly registration and reporting system will raise compliance while tempering the resistance that often springs from regulatory uncertainty. By combining technology, institutional capacity, cross-sectoral governance, fiscal diplomacy, and quality service, Indonesia can uphold an SEP-based digital income tax as a pillar of fiscal sovereignty in an era of borderless commerce.

4. CONCLUSION

This study has formulated an SEP-based unilateral digital income tax framework for Indonesia as a response to the limitations of the conventional tax system and the impasse in the multilateral settlement. The analysis shows that, of the two options opened by Law No. 2 of 2020, an SEP-based income tax is normatively superior to the PTE because it taxes profit according to ability to pay and aligns with international tax principles, even though, at the level of formal enforceability, it is more constrained by treaty provisions and thus demands careful mitigation by design (Republic of Indonesia, 2020).

To operationalise it, the study proposes a phased roadmap inspired by the CBAM transition mechanism, progressing from mandatory reporting through partial application to full application, reinforced by a high threshold, a non-discrimination principle, a two-track strategy toward tax treaties, and the strengthening of institutions and fiscal diplomacy. The study's principal contribution lies in the integration of these three elements, which the literature has hitherto tended to treat in isolation.

This study is not without limitations. As a juridical-normative study based on secondary data, it has not tested the proposed framework against primary data from the tax authority and business actors, nor has it offered a quantitative estimate of revenue potential. Further research is encouraged to explore these empirical dimensions, including modelling the revenue impact and examining administrative readiness in greater detail.

On the basis of these findings, the government is advised to prioritise the drafting of implementing regulations for Law No. 2 of 2020 in order to operationalise an SEP-based income tax, to establish an inter-ministerial task force, and to initiate economic diplomacy and the renegotiation of tax treaties with principal partner states. With these measures, a measured transition toward a fairer, more adaptive, and more sustainable digital tax system can be achieved.

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