

The Anti-Fragmentation Rule under Article 5 of the OECD Model Tax Convention: Preventing the Avoidance of Permanent Establishment Status

Matheus Putra Jaya Siregar

3203250168_matheusputra@pknstan.ac.id

Politeknik Keuangan Negara STAN

Abstract: This paper examines the anti-fragmentation rule introduced in Article 5(4.1) of the 2017 OECD Model Tax Convention (OECD MTC) as an instrument to prevent the artificial avoidance of permanent establishment (PE) status through the splitting of a single cohesive business operation among closely related enterprises. Prior to the 2017 update, Article 5(4) allowed a broad range of preparatory or auxiliary activities to be excluded from the PE definition, a gap that multinational enterprises could exploit by fragmenting an integrated commercial function into several smaller activities carried out by related entities, each individually satisfying the exemption. Although the rule has been discussed extensively in international tax literature, its interaction with Indonesia's domestic legal framework, particularly Peraturan Menteri Keuangan (Regulation of the Minister of Finance) Number 35/PMK.03/2019 and Indonesia's notified position under the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), has received comparatively little attention. Using a normative-juridical method with statutory, comparative, and conceptual approaches, this study analyzes the OECD Model Tax Convention, the BEPS Action 7 Final Report, the MLI, and Indonesian tax regulations, supported by illustrative examples, including a 2025 Indian tribunal decision applying the rule. The study finds that although Indonesia has adopted the stricter Option A under Article 13(2) of the MLI for its specific-activity exemptions, its domestic regulation has not explicitly incorporated an aggregation mechanism equivalent to Article 5(4.1), leaving a potential enforcement gap wherever no matching treaty notification, or no tax treaty at all, applies. The paper concludes that Indonesia's defenses against artificial PE avoidance would be strengthened by embedding an explicit, closely-related-enterprise aggregation rule in its domestic BUT (bentuk usaha tetap) regulations, alongside continued expansion of matched MLI notifications and strengthened inter-entity information exchange.

Keywords: permanent establishment; anti-fragmentation rule; base erosion and profit shifting; multilateral instrument; international tax

Abstrak: Artikel ini mengkaji aturan anti-fragmentasi (*anti-fragmentation rule*) yang diperkenalkan dalam Pasal 5 ayat (4.1) Model Konvensi Pajak OECD 2017 (*OECD Model Tax Convention* atau *OECD MTC*) sebagai instrumen untuk

mencegah penghindaran status bentuk usaha tetap (permanent establishment atau PE) secara artifisial melalui pemecahan satu kegiatan usaha yang terintegrasi ke dalam beberapa perusahaan yang memiliki hubungan erat. Sebelum pembaruan pada tahun 2017, Pasal 5 ayat (4) memungkinkan berbagai kegiatan yang bersifat persiapan atau penunjang dikecualikan dari definisi bentuk usaha tetap. Celah ini dapat dimanfaatkan oleh perusahaan multinasional dengan memecah suatu fungsi komersial yang terintegrasi menjadi beberapa kegiatan yang lebih kecil, yang dilakukan oleh entitas-entitas yang saling berafiliasi, sehingga masing-masing kegiatan secara individual memenuhi persyaratan pengecualian tersebut.

Meskipun aturan ini telah banyak dibahas dalam literatur perpajakan internasional, interaksinya dengan kerangka hukum nasional Indonesia, khususnya Peraturan Menteri Keuangan Nomor 35/PMK.03/2019 dan posisi Indonesia yang dinotifikasikan berdasarkan Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), masih relatif kurang mendapat perhatian. Dengan menggunakan metode yuridis normatif melalui pendekatan perundang-undangan, komparatif, dan konseptual, penelitian ini menganalisis Model Konvensi Pajak OECD, Laporan Akhir BEPS Aksi 7, MLI, serta peraturan perpajakan Indonesia. Analisis tersebut didukung oleh contoh ilustratif, termasuk putusan tribunal pajak India pada tahun 2025 yang menerapkan aturan tersebut.

Penelitian ini menemukan bahwa meskipun Indonesia telah mengadopsi Opsi A yang lebih ketat berdasarkan Pasal 13 ayat (2) MLI untuk pengecualian kegiatan tertentu, peraturan domestik Indonesia belum secara eksplisit mengakomodasi mekanisme penggabungan kegiatan yang setara dengan ketentuan Pasal 5 ayat (4.1). Kondisi ini menimbulkan potensi kesenjangan dalam penegakan hukum, terutama ketika tidak terdapat notifikasi perjanjian pajak yang bersesuaian atau ketika perjanjian penghindaran pajak berganda (P3B) tidak tersedia. Artikel ini menyimpulkan bahwa upaya Indonesia untuk mencegah penghindaran status bentuk usaha tetap secara artifisial dapat diperkuat melalui pencantuman aturan penggabungan kegiatan secara eksplisit bagi perusahaan-perusahaan yang memiliki hubungan erat dalam peraturan domestik mengenai bentuk usaha tetap (BUT), disertai dengan perluasan notifikasi MLI yang bersesuaian secara berkelanjutan serta penguatan pertukaran informasi antarentitas.

Kata kunci: *Bentuk usaha tetap; aturan anti-fragmentasi; penggerusan basis pajak dan pengalihan laba; instrumen multilateral; perpajakan internasional.*

INTRODUCTION

The development of the global economy, characterized by the mobility of capital, labor, and technology, has encouraged multinational enterprises (MNEs) to conduct business across jurisdictional boundaries. In international taxation, a country's right to tax the business profits of a nonresident taxpayer generally arises

only when that taxpayer has a permanent establishment (PE), known in Indonesian tax law as a bentuk usaha tetap (BUT), in the source state. This principle is consistently reflected in Article 7, read in conjunction with Article 5, of the OECD Model Tax Convention (OECD MTC), which serves as a reference for the majority of double taxation agreements worldwide, as well as in Article 2(5) of Law No. 36 of 2008 on the Fourth Amendment to Law No. 7 of 1983 on Income Tax (hereinafter the Income Tax Law) (Pemerintah Republik Indonesia, 2008). The PE concept therefore operates as a nexus threshold that determines whether a source state has taxing rights over business income arising from economic activities within its territory.

The importance of the PE concept as a gateway to taxation makes it a primary target of aggressive tax planning by MNEs. One of the most frequently exploited opportunities lies in Article 5(4) of the OECD MTC, which provides a negative list of activities that do not constitute a PE even when conducted through a fixed place of business. These include the storage, display, or delivery of goods; the purchase of goods; the collection of information; and other activities of a preparatory or auxiliary character. These exemptions were originally intended to exclude marginal activities that are remote from an enterprise's core profit-generating functions. In practice, however, MNEs frequently fragment an integrated set of complementary business activities among several closely related entities. Each entity, considered separately, then appears to perform only preparatory or auxiliary activities, even though the activities collectively constitute the core of the business model.

In response to such tax avoidance practices, the Organisation for Economic Co-operation and Development (OECD), together with the G20 countries, launched the Base Erosion and Profit Shifting (BEPS) project in 2013, comprising 15 action plans. Action 7, entitled Preventing the Artificial Avoidance of Permanent Establishment Status, specifically sought to close loopholes facilitating the avoidance of PE status, including through revisions to the preparatory or auxiliary activity exemptions in Article 5(4) (OECD, 2015). One concrete outcome was the introduction of the anti-fragmentation rule as the new Article 5(4.1) in the 2017 update to the OECD MTC (OECD, 2017). The rule was also incorporated into

Article 13 of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (hereinafter the MLI), a legal instrument that allows thousands of existing tax treaties to be amended simultaneously without separate bilateral renegotiations (OECD, 2016).

Indonesia participates in this global initiative as a member of the Inclusive Framework on BEPS and a signatory to the MLI since June 7, 2017. It deposited its instrument of ratification on April 28, 2020, and the MLI entered into force for Indonesia on August 1, 2020. At the domestic level, the Indonesian government issued Minister of Finance Regulation No. 35/PMK.03/2019 on the Determination of Permanent Establishments (hereinafter PMK-35/PMK.03/2019) to clarify PE criteria, including the criteria for preparatory or auxiliary activities (Kementerian Keuangan Republik Indonesia, 2019). The issue has become increasingly pressing as economic digitalization enables cross-border business models to operate with minimal physical presence. Consequently, the fragmentation of business functions, for example between marketing offices and fulfillment warehouses, has become easier to implement and more difficult for tax authorities to detect (Bayusuta, 2019; Direktorat Jenderal Pajak, n.d.).

The international literature has extensively examined the legal construction of the anti-fragmentation rule within the OECD MTC and the MLI (Garbarino, 2019), whereas the Indonesian literature has focused primarily on PE avoidance in the broader context of the digital economy. Studies specifically mapping the interaction between this internationally developed rule and Indonesia's existing tax law, particularly PMK-35/PMK.03/2019 and Indonesia's MLI position, remain relatively limited. This article seeks to address that gap by examining the extent to which Indonesia's legal framework has, or has not, adopted the principle of aggregating the activities of closely related enterprises envisaged by Article 5(4.1) of the OECD MTC.

Against this background, the study addresses three research questions. First, how does the anti-fragmentation rule in Article 5(4.1) of the 2017 OECD MTC operate, and how is it implemented through Article 13 of the MLI? Second, what is the rule's position within Indonesia's existing tax-law framework, particularly in

relation to PMK-35/PMK.03/2019 and Indonesia's MLI position? Third, to what extent can the rule effectively prevent the avoidance of PE status in Indonesia, and what challenges arise in its application?

Consistent with these questions, this study aims to analyze the legal operation, normative status, and effectiveness of the anti-fragmentation rule as an instrument for preventing tax avoidance through the manipulation of PE status, with particular emphasis on Indonesian tax law.

LITERATURE REVIEW

The Concept of a Permanent Establishment (Bentuk Usaha Tetap)

The PE concept is one of the oldest pillars of the international tax-law architecture. It can be traced to the first bilateral tax treaty between the Austro-Hungarian Empire and Prussia in 1889 and was subsequently developed by the League of Nations in the late 1920s as a model for addressing cross-border double taxation. Fundamentally, the concept represents a compromise between residence-based taxation, exercised by the taxpayer's state of residence, and source-based taxation, exercised by the state in which income arises. In the absence of a PE, the business profits of a foreign enterprise are, in principle, taxable only in its state of residence, as provided in Article 7(1) of the OECD MTC. A PE thus serves both as a prerequisite for, and a limitation on, the source state's taxing jurisdiction.

Article 5(1) and (2) of the OECD MTC define a PE as a fixed place of business through which an enterprise's business is wholly or partly carried on, accompanied by an illustrative list that includes a place of management, a branch, an office, a factory, a workshop, and a place for the extraction of natural resources. Similar provisions are adopted in Article 2(5) of Indonesia's Income Tax Law and elaborated in Article 5 of PMK-35/PMK.03/2019. The latter provides an illustrative list of business premises substantially consistent with Article 5(2) of the OECD MTC, ranging from representative offices to automated equipment used to conduct business over the internet (Kementerian Keuangan Republik Indonesia, 2019).

Conversely, Article 5(4) of the OECD MTC provides a negative list of activities excluded from the definition of a PE despite meeting the fixed-place-of-

business criteria. These include the use of facilities solely for the storage, display, or delivery of goods belonging to the enterprise; the maintenance of a stock of goods solely for the same purposes; the maintenance of a stock of goods solely for processing by another enterprise; the maintenance of a fixed place of business solely for purchasing goods or collecting information; and other activities of a preparatory or auxiliary character. The rationale for these exemptions is that such activities are considered too remote from the realization of profits to allow a specific share of those profits to be readily attributed to them (HM Revenue & Customs, n.d.).

The Evolution of Article 5 (4): From General Exemptions to a Universal Preparatory-or-Auxiliary Test

Before the 2017 update, the 2014 wording of Article 5(4) treated the activities on this negative list inconsistently. Subparagraphs (a) to (d), covering the storage, display, or delivery of goods; the maintenance of stock for processing by another enterprise; and the purchase of goods or collection of information, provided automatic exemptions without an additional requirement that the activities be preparatory or auxiliary. Only subparagraph (e) expressly imposed that requirement. The Action 7 Final Report identified this asymmetry as creating opportunities for abuse, particularly in business models heavily dependent on storage and distribution, such as online retailing. In such models, these activities may form an integral part of the enterprise's value proposition rather than merely supporting functions (Chan, 2019). The 2017 revision to Article 5(4) of the OECD MTC removed the phrase “of a preparatory or auxiliary character,” previously attached only to subparagraph (e), and added a concluding clause requiring the activities covered by all subparagraphs, (a) to (f), to satisfy the preparatory-or-auxiliary condition in order to qualify for exemption from PE status.

BEPS Action 7 and the Introduction of the Anti-Fragmentation Rule

The BEPS Action 7 Final Report (OECD, 2015) identifies three principal strategies used by MNEs to avoid PE status artificially. The first involves replacing a fully fledged distributor with a commissionaire arrangement or a similar structure

to avoid an agency PE under Article 5(5) and (6). The second involves splitting up contracts to circumvent the duration threshold for construction PEs under Article 5(3). The third involves exploiting the specific activity exemptions in Article 5(4), including by fragmenting business activities among closely related entities. The anti-fragmentation rule in Article 5(4.1) of the 2017 OECD MTC was specifically designed to address the third strategy.

In substance, the rule provides that the exemptions in Article 5(4) do not apply where an enterprise, or another enterprise closely related to it, also carries on business activities at the same place or at another place in the same country, and one of two conditions is met. Either that place itself constitutes a PE for the enterprise or the closely related enterprise, or the combined activities carried on at the two places of business, viewed as a whole, are no longer merely preparatory or auxiliary. Both alternatives are subject to the requirement that the activities carried on by the two enterprises constitute complementary functions forming part of a cohesive business operation (Chan, 2019).

For the purposes of this rule, the definition of a closely related enterprise is set out in Article 5(8) of the OECD MTC. In essence, it requires one enterprise to hold, directly or indirectly, more than 50% of the beneficial interest in the voting rights and value of the other enterprise, or vice versa, or a third party to hold more than 50% of the beneficial interest in both enterprises (OECD, 2016). This quantitative threshold is also reproduced in Article 15 of the MLI, which defines a person closely related to an enterprise for the application of various MLI provisions, including Article 13.

The Multilateral Instrument as an Implementation Mechanism

Because amendments to Article 5 of the OECD MTC serve only as a model and do not automatically modify existing tax treaties, the OECD developed the MLI as an international legal instrument enabling participating jurisdictions to amend numerous treaties simultaneously without bilateral renegotiation. The MLI entered into force internationally on July 1, 2018. Article 13, entitled Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions,

offers participating jurisdictions three policy choices: adopt Option A, which follows the 2017 approach by requiring the activities under all subparagraphs to be preparatory or auxiliary; adopt Option B, which retains the 2014 approach; or adopt neither option. Independently of that choice, Article 13(4) of the MLI provides an anti-fragmentation clause equivalent to Article 5(4.1) of the OECD MTC that may be adopted separately (Chan, 2019).

An important feature of the MLI mechanism is its requirement for matching notifications between contracting jurisdictions. An MLI provision, including the anti-fragmentation clause in Article 13(4), modifies a particular tax treaty only if both contracting jurisdictions have notified the application of the same provision and have not made conflicting reservations under Article 13(6) of the MLI (PricewaterhouseCoopers, 2018). Consequently, the coverage of the anti-fragmentation rule across a country's treaty network may vary substantially: the rule may apply to some treaty partners but not to others, depending on the combination of the two jurisdictions' positions.

Previous Studies

At the international level, Garbarino (2019) examines how developments in case law across jurisdictions have shaped the understanding of preparatory or auxiliary activities following the 2017 update, including their relationship with the anti-fragmentation rule in Article 5(4.1). Various commentators, including international BEPS monitoring groups, have also questioned the potential ambiguity of the rule's scope. In particular, they ask whether it applies only to activities supporting sales functions or more broadly to all types of preparatory or auxiliary activities, given that neither the Action 7 Final Report nor the OECD Commentary expressly limits its scope to sales-related activities.

At the national level, research on the avoidance of PE status in Indonesia has largely focused on the digital economy more generally. Bayusuta (2019) illustrates how multinational technology enterprises may use the storage-warehouse exemption to avoid PE status even where a warehouse is important to customer satisfaction and the viability of the business model. Through its official

publications, Indonesia's Directorate General of Taxes (DGT) has also identified the fragmentation of business activities as a method of artificially avoiding PE status that is relevant to economic digitalization, while noting that this strategy is relevant only to jurisdictions that have a tax treaty with Indonesia (Direktorat Jenderal Pajak, n.d.). More comprehensive academic discussions of the interpretation and application of tax treaties in Indonesia, including the PE concept, commonly draw on Darussalam, Hutagaol, and Septriadi (2010) and the subsequent volume edited by Darussalam and Septriadi (2017).

This review suggests that relatively few studies have specifically examined the gap between the international anti-fragmentation rule and Indonesia's domestic provisions, particularly PMK-35/PMK.03/2019, together with Indonesia's MLI position. This article seeks to help address that gap.

Conceptual Framework

The study's conceptual framework follows a sequence of legal developments and interactions. BEPS Action 7 prompted the introduction of the rules in Article 5(4.1) of the OECD MTC and Article 13(4) of the MLI. These rules are then incorporated into a country's tax-treaty network through reciprocal MLI notifications. Their ultimate effectiveness depends on their interaction with the country's domestic legal provisions, in this case PMK-35/PMK.03/2019 in Indonesia. This framework provides the basis for the analysis in the findings and discussion section.

RESEARCH METHODOLOGY

This study employs doctrinal legal research using a qualitative, descriptive-analytical approach. This method was selected because the research concerns the interpretation and analysis of legal rules drawn from international tax law, particularly the OECD MTC and the MLI, and Indonesia's existing tax law, rather than hypothesis testing based on quantitative empirical data.

Three complementary approaches are used. First, a statutory approach examines the text of the 2017 OECD MTC, the BEPS Action 7 Final Report, the MLI, the Income Tax Law, the Law on the Harmonization of Tax Regulations

(hereinafter the HPP Law), and PMK-35/PMK.03/2019. Second, a conceptual approach explores the fundamental concepts of a PE, nexus, and source-based taxation. Third, a comparative approach examines the adoption of the anti-fragmentation rule in selected jurisdictions, namely the United Kingdom, Italy, Australia, and India, to provide points of comparison for Indonesia.

The study relies entirely on secondary data comprising primary and secondary legal materials. The primary legal materials include the 2017 OECD MTC and its Commentary, the BEPS Action 7 Final Report, the MLI, the Income Tax Law, the HPP Law, and PMK-35/PMK.03/2019. The secondary legal materials include books, national and international scholarly journal articles, official DGT publications, tax practitioners' analyses, and reports by international organizations relevant to the research topic.

Data were collected through library research on these documents. The analysis is qualitative and deductive: it first identifies the general rules contained in the OECD MTC and the MLI, then examines their concrete application within Indonesia's existing legal framework. Illustrative cases are used to assess the logical consistency of the application of these rules.

The study has a methodological limitation in that it is doctrinal and does not involve the collection of primary field data, such as interviews with tax authorities or taxpayers, or the analysis of tax-compliance data. Accordingly, its findings should be understood as a normative analysis that may be further developed through future empirical research.

FINDINGS AND DISCUSSION

The Legal Operation of the Anti-Fragmentation Rule under Article 5(4.1) of the 2017 OECD MTC

As explained in the literature review, the application of Article 5(4.1) of the 2017 OECD MTC requires three cumulative elements. First, two business activities must be carried on at the same place, or at different places within the same country, either by the same enterprise or by closely related enterprises. Second, one of two alternative conditions must be satisfied: the relevant place of business already

constitutes a PE under another provision of Article 5, or the combined activities at the two places of business, assessed as a whole, are no longer merely preparatory or auxiliary. Third, as a limiting condition on the first two elements, the activities performed by the two enterprises must constitute complementary functions forming part of a cohesive business operation.

Chan's (2019) analysis of Article 13 of the MLI identifies two principal situations in which the provision is relevant. In the first, a nonresident enterprise already has a PE in the source state, established either directly or through a closely related entity. The legal question then becomes whether other activities fragmented among related entities should be aggregated with that existing PE. In the second, no PE yet exists, but the activities of the enterprise and its closely related entities, when assessed together, exceed the preparatory-or-auxiliary threshold and therefore give rise to a new PE. In both situations, the essence of the legal test is the same: the combined activities of related entities are assessed as a functional whole rather than as independent units.

The quantitative definition of a closely related enterprise under Article 5(8) of the OECD MTC, based on more than 50% of the beneficial interest, voting rights, or value, provides a relatively high degree of legal certainty compared with a purely qualitative concept of relatedness. Nevertheless, this quantitative threshold also means that cross-ownership arrangements below 50%, even where they economically reflect common control, fall outside the scope of the aggregation test in Article 5(4.1). This feature warrants attention when planning cross-border corporate structures.

Illustrations of the Application of the Anti-Fragmentation Rule

To illustrate the rule's application more concretely, the OECD Commentary on Article 5 provides the following example. Company R, resident in one country, maintains a warehouse in Country S solely to store its own goods, an activity ordinarily exempt under Article 5(4)(a) or (b). R also owns a subsidiary in Country S, Company S, which operates a retail store selling R's products. The store's employees regularly collect goods directly from R's warehouse. Because R and

Company S are closely related enterprises, and their respective activities, storage and distribution on the one hand and retail sales on the other, are complementary functions forming part of a cohesive business operation, Article 5(4.1) aggregates the two activities. R's warehouse is consequently regarded as constituting a PE of R in Country S, even though, considered separately, it would otherwise qualify for the storage exemption (OECD, 2017).

This illustration is directly relevant to the digital economy, an area that has long attracted the attention of Indonesia's tax authorities. Bayusuta (2019) presents a similar example: a multinational technology enterprise resident in Country X sells goods online and establishes a warehouse in Country Y solely to expedite the delivery of customers' orders. Under generally applicable PE exemptions, the warehouse does not, by itself, constitute a PE in Country Y. Closer examination, however, reveals that delivery speed is critical to customer satisfaction and the viability of the online retail business model. The warehouse therefore adds significant value rather than merely performing an auxiliary function.

To clarify how the test may apply in Indonesia, the author develops the following hypothetical illustration for academic purposes. XYZ Corp, a tax resident of one of Indonesia's treaty partners, operates a cross-border online retail business. It establishes a representative office in Jakarta solely to collect market information and identify trends in Indonesian consumer preferences, an activity falling within Article 5(4)(d). At the same time, XYZ Corp indirectly owns all the shares in PT XYZ Logistik through its ownership chain, thereby satisfying the more-than-50% threshold for closely related enterprises under Article 5(8) of the OECD MTC. PT XYZ Logistik operates a fulfillment warehouse in Indonesia that receives, stores, and dispatches goods ordered by Indonesian customers through XYZ Corp's digital platform. Table 1 summarizes the PE-status analysis of this illustration before and after the aggregation test in Article 5(4.1) is applied.

Table 1. Analysis of PE Status in the XYZ Corp Illustration Before and After Application of the Anti-Fragmentation Rule

Entity	Principal activities	Status under Article 5(4) (Separate assessment)	Status after Article 5(4.1) (Combined assessment)
XYZ Corp (representative office, Jakarta)	Collection of market information and consumer preferences	Exempt as a preparatory activity under Article 5(4)(d)	Remains subject to assessment, but now as part of the combined analysis
PT XYZ Logistik (subsidiary)	Receipt, storage, and rapid dispatch of customer orders	Exempt as storage or delivery activities under Article 5(4)(a) or (b)	May constitute a complementary function essential to the business model
Combined (XYZ Corp and PT XYZ Logistik)	Market-information-based marketing and rapid order fulfillment as an integrated online retail model	Not applicable; each entity is assessed separately	May no longer be merely preparatory or auxiliary; a PE may arise if the treaty adopts Article 13(4) of the MLI

Source: Prepared by the author, adapted from the illustrations in the OECD Commentary on Article 5 of the OECD MTC (OECD, 2017) and Bayusuta (2019).

As shown in Table 1, when each entity is assessed separately, both the representative office and PT XYZ Logistik appear to qualify for PE exemptions. However, XYZ Corp and PT XYZ Logistik are closely related enterprises, and the collection of market information and rapid order fulfillment represent two aspects of a cohesive online retail business model. Delivery speed and reliability are core components of the value proposition of such digital platforms rather than merely supporting functions. Their combined activities may therefore no longer be merely preparatory or auxiliary. Consequently, provided that the relevant treaty between Indonesia and XYZ Corp's state of residence has adopted the anti-fragmentation clause in Article 13(4) of the MLI, PT XYZ Logistik's fulfillment warehouse, or even XYZ Corp's combined presence in Indonesia, may be regarded as constituting a PE.

By comparison, Indian judicial practice illustrates the limits of the rule's application. In *RGA International Reinsurance Company Designated Activity Company v. DCIT*, the Mumbai bench of India's Income-tax Appellate Tribunal held that an Irish reinsurance company had neither a fixed-place PE nor a

dependent-agent PE in India, even though its Indian affiliate provided preparatory and auxiliary support services. The tribunal also considered the MLI-based anti-fragmentation rule under the India-Ireland tax treaty but concluded that it did not apply because the core function of assuming reinsurance risk was performed entirely by the taxpayer outside India. The activities of the taxpayer and its Indian affiliate therefore did not qualify as complementary functions forming part of a cohesive business operation within India (KPMG, 2025). The decision emphasizes that applying the anti-fragmentation rule requires careful factual substantiation of the functional relationship between entities and cannot be based solely on affiliation or ownership links.

The Anti-Fragmentation Rule in Comparative Jurisdictional Practice

Jurisdictions have adopted the anti-fragmentation rule through varying approaches. In the United Kingdom, section 21 of the Finance Act 2019 amended section 1143 of the Corporation Tax Act 2010 (UK Public General Acts, 2019) to incorporate an explicit definition of a fragmented business operation directly into domestic legislation. Under this approach, the United Kingdom's anti-fragmentation rule operates autonomously under domestic law, regardless of whether a treaty exists with the partner jurisdiction or whether MLI notifications match. Italy took a similar approach by amending Article 162 of the *Testo Unico delle Imposte sui Redditi*, its consolidated income tax legislation, under the 2018 Budget Law, thereby incorporating an anti-fragmentation clause into its domestic PE definition (Lexology, 2018).

Unlike the United Kingdom and Italy, Australia and India have pursued adoption through tax treaties modified by the MLI. Australia selected Option A under Article 13(2) of the MLI for most of its treaties, while the application of the anti-fragmentation clause in Article 13(4) varies according to matching notifications with individual treaty partners. Indian practice, as reflected in the RGA International case discussed above, indicates that anti-fragmentation clauses adopted through MLI-modified treaties have begun to be examined and applied by domestic tax adjudicatory bodies.

This comparison reveals two distinct regulatory models. The “full domestic incorporation” model, followed by the United Kingdom and Italy, makes the anti-fragmentation rule generally applicable without depending on the treaty network. The “treaty-based adoption” model, followed by Australia and India, depends entirely on treaty coverage and matching treaty/MLI notifications for its effectiveness. As discussed in the following subsection, Indonesia currently tends toward the second model without expressly incorporating the aggregation principle into domestic law.

The Position of the Anti-Fragmentation Rule within Indonesian Law

Indonesia's domestic PE provisions derive from two levels of regulation. At the statutory level, Article 2(5) of the Income Tax Law provides the general definition of a PE and an illustrative list of its forms. At the implementing-regulation level, PMK-35/PMK.03/2019 elaborates the PE criteria, including the requirements for a place of business in Articles 4 and 5 and the criteria for preparatory and auxiliary activities in Article 6. Notably, the definition of essential and significant activities in Article 6(4) of PMK-35/PMK.03/2019, which provides the conceptual counterpart to preparatory or auxiliary activities, is carefully formulated. It covers activities that constitute the core business, form an inseparable part of the core business, directly generate income, or involve significant assets or human resources. In substance, this aligns with the essential-and-significant test in the OECD Commentary (Kementerian Keuangan Republik Indonesia, 2019).

Nevertheless, an examination of PMK-35/PMK.03/2019 indicates that it does not provide a mechanism for aggregating the activities of closely related enterprises as envisaged by Article 5(4.1) of the OECD MTC. The only restriction on the preparatory or auxiliary activity exemption in PMK-35/PMK.03/2019 appears in Article 6(5), which states that the exemption does not apply where such activities are performed “for other parties.” That provision addresses a different factual pattern: the provision of preparatory or auxiliary services to third parties outside the relevant business group, rather than the fragmentation of business functions among closely related enterprises within the same group, which is the principal target of

Article 5(4.1). Nor does PMK-35/PMK.03/2019 cross-reference the concept of related-party relationships recognized elsewhere in Indonesian tax law, such as Article 18(4) of the Income Tax Law, which underpins the transfer-pricing rules, for the purposes of aggregating activities in the determination of PE status.

As a consequence of this regulatory gap, the application of the anti-fragmentation principle to nonresident taxpayers in Indonesia, at the time of this study, is possible only through MLI-modified tax treaties, and only where three cumulative conditions are met. First, Indonesia must have a tax treaty with the relevant partner jurisdiction. Second, that treaty must be included in Indonesia's list of Covered Tax Agreements (CTAs) notified under the MLI. At the time Indonesia deposited its instrument of ratification, this list comprised 47 treaties and was subsequently expanded through additional notifications. Third, the treaty partner must also have notified the application of the anti-fragmentation clause in Article 13(4) of the MLI in a manner that matches Indonesia's position. Indonesia has selected Option A under Article 13(2), consistent with the universal approach of the 2017 OECD MTC. This choice itself tightens the conditions for specific activity exemptions, independently of whether the separate anti-fragmentation clause in Article 13(4) applies. Nevertheless, determining which treaties have specifically achieved matching notifications for that clause requires treaty-by-treaty verification through the OECD's MLI Matching Database, because the outcome depends on the combination of both contracting jurisdictions' positions.

This structure gives rise to two potential gaps. The first concerns treaties that are in force but have not, or do not, achieve matching notifications under Article 13(4) of the MLI. In those treaty relationships, protection against fragmentation depends solely on Indonesia's adoption of Option A, which tightens the preparatory-or-auxiliary condition for each activity individually but does not provide a cross-entity aggregation mechanism. The second, more fundamental conceptual gap arises where no tax treaty exists and the applicable rules derive solely from PMK-35/PMK.03/2019, which, as discussed above, contains no aggregation mechanism based on closely related enterprise status. In that situation, a business group could theoretically divide its functions among several related entities established in

Indonesia so that each entity, assessed individually, continues to qualify for the preparatory or auxiliary activity exemption under Article 6 of PMK-35/PMK.03/2019, without being subject to a mechanism equivalent to Article 5(4.1) of the OECD MTC.

Indonesia has also developed another unilateral instrument to address the taxation challenges of the digital economy: the concept of significant economic presence for foreign businesses engaged in trade through electronic systems (Perdagangan Melalui Sistem Elektronik, or PMSE). This concept was first introduced through Government Regulation in Lieu of Law No. 1 of 2020, and its legal basis was subsequently reinforced through the HPP Law (Pemerintah Republik Indonesia, 2021). The instrument allows income tax or electronic transaction tax to be imposed on nonresident taxpayers that have no physical presence in Indonesia but meet specified economic-presence thresholds. However, significant economic presence is designed to address a different scenario, namely the complete absence of physical presence, rather than the fragmentation of business functions among entities that maintain a partial physical presence in Indonesia, as contemplated by Article 5(4.1) of the OECD MTC. The two instruments are therefore complementary rather than interchangeable, and the absence of an anti-fragmentation provision in PMK-35/PMK.03/2019 remains an issue requiring separate attention.

Effectiveness and Implementation Challenges in Indonesia

The preceding analysis indicates that the effectiveness of the anti-fragmentation rule as an instrument for preventing the avoidance of PE status in Indonesia is partial and highly dependent on the applicable treaty context. In treaty relationships with matching notifications under Article 13(4) of the MLI, Indonesia essentially has a legal instrument aligned with international standards. Beyond that context, however, at least four principal challenges remain.

The first challenge is dependence on the treaty network and reciprocal notification mechanisms, resulting in uneven coverage and requiring case-by-case verification. The second is the absence of an aggregation mechanism for closely

related enterprises in PMK-35/PMK.03/2019, which confines the reach of the anti-fragmentation principle to situations covered by MLI-modified treaties. The third challenge is evidentiary. Establishing that the activities of two entities constitute complementary functions within a cohesive business operation requires access to information that is often dispersed across different taxpayers and even different jurisdictions. This is illustrated by the RGA International case, in which the failure to establish the requisite functional relationship was decisive. The fourth challenge concerns the characteristics of the digital economy, where transaction functions, such as online marketing and sales, are increasingly separated from fulfillment functions, such as warehousing and logistics. Both the DGT and tax practitioners have drawn attention to this development, while the available significant-economic-presence instrument may not necessarily address scenarios involving a residual, partial physical presence.

Drawing on the full domestic incorporation approach adopted by the United Kingdom and Italy, Indonesia could consider strengthening its legal framework by inserting an explicit aggregation provision for closely related enterprises into PMK-35/PMK.03/2019 or its successor regulation, with reference to the concept of related-party relationships already recognized in Article 18(4) of the Income Tax Law. This measure would ensure that the anti-fragmentation principle applies consistently in both treaty and non-treaty situations, without depending entirely on the contingent matching of MLI notifications.

CONCLUSIONS DAN RECOMMENDATIONS

This study reaches three principal conclusions corresponding to its research questions. First, the anti-fragmentation rule in Article 5(4.1) of the 2017 OECD MTC and Article 13(4) of the MLI is a legal mechanism that aggregates the activities of two or more closely related enterprises where those activities constitute complementary functions forming part of a cohesive business operation. It thereby prevents the preparatory or auxiliary activity exemptions in Article 5(4) from being exploited artificially through the fragmentation of corporate structures.

Second, the incorporation of the anti-fragmentation rule into Indonesia's existing legal framework remains incomplete. Indonesia has adopted Option A under Article 13(2) of the MLI, which subjects the specific activity exemptions to the preparatory-or-auxiliary requirement in treaties to which that provision applies. The anti-fragmentation rule governing the aggregation of activities of closely related enterprises, corresponding to Article 5(4.1) of the OECD MTC, is provided separately under Article 13(4) of the MLI. Consequently, where the relevant treaty is modified by matching MLI positions, the treaty-based application of the anti-fragmentation rule depends on the corresponding notifications of Indonesia and its treaty partner. In the absence of an applicable treaty provision, PMK-35/PMK.03/2019 does not provide an equivalent domestic aggregation mechanism.

Third, the anti-fragmentation rule is only partially effective as an instrument for preventing the avoidance of PE status in Indonesia. The principal challenges include reliance on an uneven treaty network and treaty/MLI notifications, the absence of a domestic aggregation mechanism, difficulties in establishing functional relationships between entities, and the characteristics of the digital economy that facilitate the separation of transaction functions from order-fulfillment functions.

The study contributes a systematic mapping of the interaction between the international anti-fragmentation rule and Indonesia's domestic legal framework, a perspective that, to the best of the author's knowledge, has received limited specific attention in the Indonesian tax literature. Its limitation lies in its doctrinal nature: the analysis is not supported by empirical evidence on tax-audit practices or Indonesian Tax Court decisions expressly testing the anti-fragmentation principle. At the time of writing, no domestic precedent directly addressing this issue had been identified.

Based on these conclusions, the study offers three recommendations. Policymakers should consider incorporating an explicit provision for aggregating the activities of closely related enterprises into PMK-35/PMK.03/2019 or its successor regulation, with reference to, but not necessarily limited to, the related-party criteria under Article 18(4) of the Income Tax Law, so that the anti-

fragmentation principle applies consistently in both treaty and non-treaty contexts. Continued efforts should also be directed toward expanding the coverage of matching notifications under Article 13(4) of the MLI across Indonesia's relevant treaties and strengthening mechanisms for exchanging information across entities and jurisdictions. Future research should empirically examine tax-audit practices and monitor developments in the Indonesian Tax Court and tax adjudicatory bodies in other jurisdictions that are beginning to address anti-fragmentation issues, including estimates of their implications for potential revenue from international taxation.

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