Data Centres and Taxes: Inside the Tax Incentive Framework

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I. Introduction

India's growing digital infrastructure is driving demand for data centres, business models involving overseas technology companies, Indian data centre operators and local resellers. Against this backdrop, cross-border taxation and allocation of taxing rights across jurisdictions becomes vital, and recent changes to India's tax framework seek to provide clarity on the taxation and transfer pricing implications of such arrangements.

The Income-tax Act, 2025 ("IT Act 2025") was recently amended to exempt foreign companies from tax on its taxable income earned from procuring data centre services in India till 31 March 2047. Further relaxation of the exemption conditions is proposed by the Taxation and Other Laws (Amendment) Bill, 2026 ("TOLA"). The provisions of TOLA are not effective as of date and will be effective, once the parliamentary procedures are completed and the presidential assent is received. These amendments aim to promote long-term investment in data centres, the backbone of the Artificial Intelligence ("AI") services industry.

II. Specific regime for data centre services availed by foreign companies

Several stakeholders contribute to India's data centre ecosystem, including global cloud and technology providers, Indian infrastructure and data centre developers, construction companies, power generators and equity and debt investors.

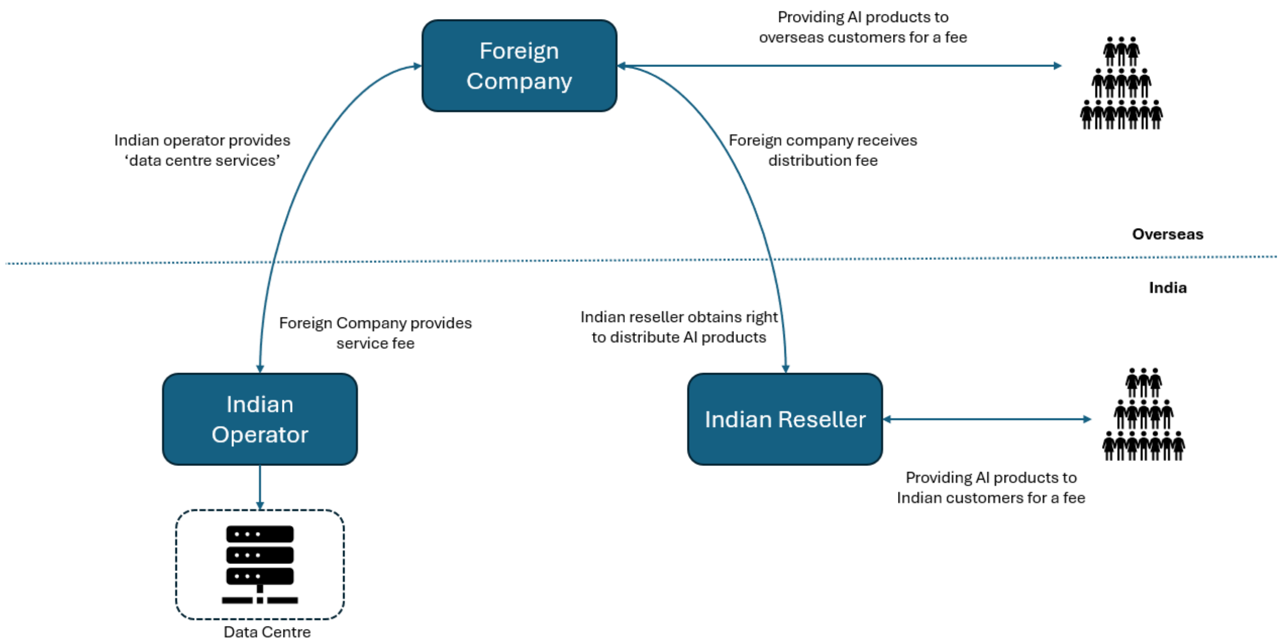
From an Indian income-tax standpoint, the foreign company availing data centre services from an Indian datacentre, can qualify for 100% tax exemption subject to certain conditions and a bare reading of the exemption provision contemplates the following business model: -

Step 1: An Indian company (the "Indian Operator") operates a data centre in India (which it owns or leases, as proposed by TOLA[1])

Step 2: A foreign company obtains 'data centre services' from such Indian Operator.

Step 3: The foreign company procures these 'data centre services' to onward sell / render services to its users. Sales to Indian users would be through an Indian company (the "Indian Reseller").

1 As proposed by the TOLA



Within this framework, the taxation regime introduces two key provisions:

A. Tax exemption for foreign companies

The tax exemption[2] provides that any income accruing or arising in India or deemed to accrue or arise in India by way of 'procuring data centre services' from a 'specified data centre' should be exempt from tax in the hands of a foreign company.

The IT Act 2025 defines a 'data centre' as a dedicated secure space where computing and networking equipment is concentrated for collecting, storing, processing, distributing or accessing large amounts of data. 'Data centre services' cover services provided through physical infrastructure (land, buildings, power, cooling, security) and IT infrastructure (servers, storage, operating systems, security solutions, network platforms, networking equipment and associated software), together with human resources in India.

The scope of the exemption should ordinarily apply to global income earned from sale of data centre services procured from the Indian Operator and not limited to India-sourced income. Per the proposed TOLA, foreign companies need not be separately notified by the central government. However, two key conditions continue to be applicable:

- the foreign company must not own or operate the physical infrastructure or resources of the specified data centre ("Operating Condition"); and
- all sales to users located in India must be routed through the Indian Reseller ("Reseller Condition").

Previously, foreign companies may have taken the position that their global income is not taxable in India, absent a "permanent establishment" ("PE") under Indian tax treaties. That position was litigation-prone, particularly where the foreign company controlled the equipment deployed in India.

2 Item 13C of Schedule IV to the IT Act 2025

The domestic tax exemption therefore provides an additional layer of certainty, reducing reliance solely on treaty-based protection.

B. Transfer pricing safe harbour for related parties

Complementing the exemption, the Income-tax Rules 2026 introduce a transfer pricing safe harbour for Indian Operators rendering data centre services to associated foreign entities, under which the transfer price is accepted where the operating profit margin (on operating expenses) is not less than 15%.

The safe harbour is limited to transactions between the Indian Operator and its overseas associated enterprise and does not extend to subsequent transactions between the foreign company and an Indian Reseller (where associated), which remain subject to applicable transfer pricing provisions.

III. Other considerations

The regime does not address all aspects of tax treatment of data centre operations and general provisions of the IT Act 2025 continue to apply to matters not covered by the exemption or safe harbour.

For example, there is no express tax exemption for Indian Operators (unless qualifying as a GIFT City setup) or their shareholders/lenders, whether resident or non-resident (subject to treaty relief). Dividend received by the shareholders of the Indian Operators will also be taxable at their applicable tax rates (unless the dividend is received from GIFT City unit, in which case it will taxable at the rate of 10% plus applicable surcharge and cess for non-resident shareholder). However, sovereign wealth funds investing in Indian Operators may benefit from exemptions on dividend, interest or long-term capital gains.

A. Withholding tax on lease payments

TOLA has proposed to relax the statutory conditions for claiming the exemption and permitted Indian Operators to lease data centre assets. Data centre operations may also involve a leasing activity, of physical space, power and cooling infrastructure, or computing hardware such as graphics processing units ("GPUs") as service.

Payments by Indian entities toward lease of such assets in case of residents and for non-residents (subject to applicable laws permitting leasing) may attract withholding tax under the IT Act 2025. The characterization of the payment, as rent, royalty or fees for technical services or whether it constitutes any taxable presence in India for non-residents, will determine the applicable rate. The precise treatment depends on the contractual structure, nature of the asset and classification under the IT Act 2025 and any applicable tax treaty

Leasing structures under the GIFT IFSC, which typically exempt interest paid by a GIFT unit, may warrant evaluation from regulatory and tax perspective as well.

B. Depreciation / lease payments for data centre assets

The availability of depreciation on the infrastructure for data centre (such as servers, networking equipment, cooling systems and building infrastructure) or deduction for lease payments for such assets would need to be evaluated based on the ownership of the infrastructure and whether the arrangement is, in substance, a financing arrangement or a lease.

C. Taxation of the foreign company where exemption conditions are not met

Where exemption conditions are not satisfied (e.g., the foreign company owns or operates physical infrastructure or sales to Indian users are not routed through the Indian Reseller), ordinary Indian taxation principles apply.

The foreign company's India-sourced income will be chargeable under the IT Act 2025, and it must be examined whether the income arises from a 'business connection' in India, which includes a 'significant economic presence' ("SEP"). SEP exists where the foreign company has 300,000 or more users in India in the previous year or aggregate payments of INR 2 crore or more from transactions with Indian residents. Subject to treaty language, relief may be claimed under the relevant tax treaty.

D. PE: Can servers or data centre equipment constitute a PE?

A question of significance is whether computers, servers or other data centre equipment located in India can constitute a PE of the foreign company for purposes of bilateral tax treaties.

The OECD Commentary on Article 5 of the Model Tax Convention acknowledges that a server (as distinct from a website hosted on it) may constitute a "fixed place of business" PE. The analysis turns on whether the equipment is at the foreign enterprise's disposal, ie whether it has effective control over the equipment on a continuing basis (eg employees operating the servers or remote controlled by the foreign company).

Evaluating the foreign company's 'control' over the servers is critical, as a key exemption condition is that the servers are 'operated' by the Indian Operator. Ambiguity remains over what constitutes 'operating' the servers, and excessive control rights could result in denial of the exemption and heightened PE risk.

Indian jurisprudence has been controversial. Disputes in Amadeus Global Travel Distribution SA[3] and Mastercard Asia Pacific Pte. Ltd.[4] examined when computing infrastructure in India gives rise to a PE, with courts scrutinising actual control, the nature of operations and the substance of the arrangement. The emerging principle is that a substance-over-form evaluation of the foreign company's control, access and use of the equipment is determinative.

By requiring that the foreign company must not own or operate the physical infrastructure, the exemption is designed to ensure qualifying arrangements do not give rise to PE concerns. Where the conditions are not met, PE risk must be assessed on facts. Additionally, taxability as royalty or FTS at 21.84% (reduced under an applicable treaty) must be evaluated under the relevant tax treaty and the IT Act.

Conclusion

By offering exemptions for foreign companies and safe harbour provisions for Indian operators, the framework provides clarity in an evolving digital economy. Taxpayers should assess adherence to the prescribed conditions, while also accounting for withholding obligations, depreciation treatment and PE risks, alongside entity choice, funding, treaty benefits, robust documentation of cloud computing, service arrangements, rental and leasing arrangements and transfer pricing compliance. As the regulatory landscape develops, further government clarifications will be essential to address interpretational ambiguities.

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3 [2011] 11 taxmann.com 153 (Delhi)
4 [2018] 94 taxmann.com 195 (AAR - New Delhi)