

Reworking the Tax Framework in a Permanently Established AI Era

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Artificial Intelligence or AI has fundamentally reshaped cross-border operations of businesses and professions. As enterprises increase the usage of AI-driven tools, algorithms, and virtual agents to cater to overseas markets, traditional dimensions of tax presence are being tested in new ways. Similarly, as AI companies themselves engage in developing, training, and deploying of technology across jurisdictions, they are also faced with the question of tax presence from another vantage point. The ever-evolving means of creating and using technology now requires law and policy makers to regularly revisit the dimensions of cross-border taxation regime.

At the heart of cross border taxation law lies the construct of Permanent Establishment (PE). Generally speaking, PE is a formal threshold which determines when a foreign enterprise has sufficient footing or nexus in a jurisdiction to warrant taxation in that jurisdiction. Traditionally, PE as a concept is rooted in physical presence and human agencies. However, the contours of this concept now need to be tested by AI systems that can generate significant economic value in a country without any meaningful physical or human presence.

India occupies a unique position in the discourse surrounding permanent establishments. It has proactively expanded its tax nexus rules through the Significant Economic Presence (SEP) provisions and the erstwhile Equalization Levy, signalling a clear intent to tax digital economy profits. However, the fundamental PE framework under India's tax treaties still leaves a void in exploring the boundaries of digital nexus, creating significant interpretive challenges when AI is deployed across borders.

The Indian tax nexus framework

Indian tax law subjects to tax any income which is sourced to India through a “business connection” in India. This broad domestic law concept is replaced by, and also constrained by PE definitions in India's extensive network of Double Taxation Avoidance Agreements (DTAAs).

The PE concept under India's DTAAs encompasses several categories, including a fixed place PE (a fixed place of business through which the enterprise carries on its business), an agency PE (a dependent agent who habitually exercises authority to conclude contracts), a service PE (furnishing of services by manpower for a specified duration), and the construction PE. Each of these categories may potentially be linked to the deployment of AI systems in India, though in ways that the treaty drafters could not have anticipated.

Fixed Place PE and AI Infrastructure

The OECD Commentary on Article 5 recognizes that a server, being a physical equipment, can constitute a fixed place of business and therefore a PE. Jurisdictionally, even the Indian judiciary continues to ponder on the contribution of an automated equipment in creation of a PE, while deciding on the challenge to AAR ruling in the case of Mastercard Asia Pacific.

In this background, if a foreign enterprise's AI model runs on servers located outside India and Indian users simply access it remotely, the traditional fixed place PE test may be hard to satisfy, since there is no physical infrastructure or presence in India. On the contrary, when a foreign enterprise installs AI models on servers physically located in India, the discussion on fixed place PE gains relevance due to physical nexus.

Similarly, when AI is deployed by a foreign enterprise on a shared physical infrastructure which is owned by a third-party Indian entity, the pivotal inquiry becomes whether the foreign enterprise has the server "at its disposal" as per the test laid down by Supreme Court in Formula One World Championship Ltd. vs. CIT. Under prevailing interpretive approaches, a mere right to computing resources on a shared infrastructure, without exclusive possession of specific equipment, may not satisfy this threshold. However, in the case of edge computing where AI models are run locally on devices or servers located in India, the conventional PE risk may be invoked if the foreign enterprise's business is being carried on, even partly, through hardware physically located in India.

In these scenarios, foreign enterprises may explore the exception of "preparatory or auxiliary" activities to examine whether AI activities such as data collection, model inference, or user profiling can be characterized as merely preparatory to the enterprise's core business. However, if AI usage itself increasingly constitutes the core revenue-generating activity, this characterization becomes increasingly difficult to sustain.

Can AI Be a "Dependent Agent"?

India's bilateral tax treaties also provide for a PE that arises where a person, being a dependent agent, acts on behalf of an enterprise and habitually exercises authority to conclude contracts in the name of that enterprise. The critical doctrinal question is whether AI can constitute a dependent agent in these circumstances.

With enhanced autonomous abilities, activities of AI systems may fall in the grey zone of dependent agents. The usage of AI has increased over time in programmatic advertising platforms committing advertising spend, algorithmic trading systems executing binding financial transactions, or automated procurement systems placing purchase orders, without real-time human involvement. Even if the AI system itself may not be treated as an agent, the humans who deploy, train, supervise, or maintain the AI in India could potentially be characterized as dependent agents. Their role in configuring the AI to conclude contracts on the enterprise's behalf may satisfy the "habitually exercises authority" requirement.

Interestingly, in India's broader "business connection" context, the section does not require a "person" in the same strict sense as the treaty-based agency PE. This means that AI activities generating revenue in India may be captured more readily under domestic law than under treaty-based PE definitions, subject, of course, to treaty override protections.

Significant Economic Presence (SEP): India's Expanded Nexus

Recognizing the limitations of the traditional PE concept, India broadened the scope of business connection to include SEP. Thus, a non-resident may be deemed to have an SEP in India if: (a) it undertakes transactions in respect of goods, services, or property with any person in India, including downloading of data, where payments for such transactions exceed the prescribed threshold of INR 2 crores; or (b) it systematically and continuously solicits business activities or engages in interaction with a prescribed number of users (3 lakh users) in India through digital means.

AI-powered platforms can easily satisfy these thresholds. An AI platform providing software as a service or an AI-driven marketplace systematically engaging Indian users, is likely to meet the SEP criteria. However, SEP is subject to tax treaty limitations and cannot override PE definitions in existing treaties. Its effective application therefore depends on India renegotiating its bilateral treaties to incorporate SEP-like provisions.

Profit Attribution : a bigger battle than Nexus

Under Indian tax treaties, generally, profit attribution is carried out either using the “force of attraction” principle under UN Model or through OECD approach which attributes profits based on the functions, assets, and risks (FAR) analysis of the PE, as if it were a separate enterprise. Under Indian tax law, profit attribution to a business connection or PE is instead governed by the Income-tax Rules, 2026. In practice, Indian courts have often layered these provisions with FAR analysis, to assess profits that remain attributable to a PE after arm's length remuneration.

AI-based business operations challenges this framework. The debate is likely to circle around whether a business operating through algorithms, cloud infrastructure and remote personnel can have a PE in a market jurisdiction and if yes, whose functions, assets, and risks should determine the attribution analysis. For instance, an FAR analysis in association with an algorithm would have to be conducted after taking into account the location of the server executing the code, the developer's office where the code was designed, or the source of the data feeding it.

Even if a PE exists, the exercise of profit attribution will confront a fundamental dichotomy, i.e., the valuable components of the business – such as the model, training architecture, intellectual property, and strategic decision-making – are located in one jurisdiction, while the commercial value is continuously derived from customers, data, interactions, and deployment in a different jurisdiction. Thus, the looming elementary question remains whether the present tools of profit attribution will suffice in the era of AI.

The transfer pricing implications further add to the complexity. When an enterprise provides proprietary AI tools to its Indian PE or subsidiary, the question arises whether this is a license of intellectual property or a provision of an intra-group service. Historically, India's profit attribution approach has been perceived as hardline, where Indian tax authorities have attributed profits after applying force of attraction doctrine expansively. AI could amplify these disputes, given the practical challenge of valuing AI's contribution in instances where the algorithm's value derives from centrally developed IP but the value creation happens locally.

Was Equalization Levy the solution?

India had also introduced the Equalization Levy as a stopgap measure which operated outside the treaty framework. The Equalisation Levy was not only limited to digital advertising services but was eventually extended to e-commerce supply or services. AI-driven business models could have fallen within the scope of this levy. However, the e-commerce Equalization Levy was withdrawn effective April 1, 2025, as India engaged with the OECD/G20 Pillar One framework. This withdrawal leaves a potential gap in India's ability to tax AI-driven economic value unless Pillar One is successfully implemented or PE rules are modernized to address AI-specific challenges.

Is India prepared for the overhaul?

Indian lawmakers have already acknowledged the need to prepare for the onset of AI. Recent amendments under the Income-tax Act, 2025 usher in tax holidays for foreign companies using data centre infrastructure in India. These changes reflect a broader policy intent to position India as a competitive hub for global data centre and cloud investment, while easing associated compliance and approval requirements.

India has demonstrated proactive intent in taxing the digital economy through SEP and the Equalization Levy. However, both measures carry inherent limitations, namely, SEP's inability to override existing treaty protections, and the Equalization Levy being partially withdrawn. The core PE framework, which has been traditionally designed for a physical, human-driven economy requires fundamental reworking to address AI-driven value creation.

Globally, approaches such as OECD Pillar One also offer a solution in the form of mechanisms which are expressly designed to allocate part of the profits of very large and profitable groups to market jurisdictions even without conventional physical presence. Similarly, Article 12B of the UN Model offers a treaty approach to automated digital services. The UN is now examining whether existing rules adequately address emerging technologies, including AI and machine learning. These approaches may further be streamlined to address the AI-related PE concerns. That said, the interplay of AI, PE, and profit attribution will undoubtedly be one of the most defining international tax issues of the coming decade.
