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THE EROSION OF PHYSICALITY: EVALUATING THE 'VIRTUAL PERMANENT ESTABLISHMENT' AND INCOME CHARACTERIZATION OF AI SAAS UNDER THE INCOME-TAX ACT, 2025

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Abstract

The rapid evolution of Artificial Intelligence from a mere static software to autonomous Software-as-a-Service (SaaS) models has changed the traditional "brick-and-mortar" foundations of international taxation. This paper goes into this critical legal impasse in India's 2026 tax landscape, which is characterized by the repeal of the Equalization Levy in 2025 and the subsequent implementation of the Income Tax Act, 2025. By analyzing the transition toward OECD Pillar One, the research identifies a significant "Mid-Tier Gap" where high-growth AI firms that do not fulfill the Euro 20 billion revenue threshold are subjected to more aggressive domestic "Royalty" re-characterizations and "Virtual Permanent Establishment" assessments.

The paper delves into the characterization conflict under section 9 of the New Act, arguing that the "Secret Process" doctrine is an archaic fit for the "Black Box" nature of generative AI neural weights. It discusses recent judicial developments, including the Delhi High Court's 2025-26 rulings on digital presence and the Supreme Court's expanded "disposal test" in Hyatt International (2025)[1], which suggests a shift toward a "Compute-based Nexus." The paper further contrasts India's source-based aggression with the EU AI Act's[2] data-value nexus and the United States' defensive treaty supremacy.

Concluding with normative recommendations, the paper proposes a "New Digital Tax Constitution" consisting of an "AI-Inference Safe Harbor" and a codified "Hardware-PE" rule based on functional control over GPU clusters. These reforms aim to replace the current "Taxation by Litigation" cycle with a "Taxation by Design" framework, ensuring tax neutrality for domestic innovators while providing the legal certainty required for foreign AI providers

[1] Hyatt International Southwest Asia Ltd. v. ADIT, (2025) SCC OnLine SC 4122.
[2] EU AI Act, art. 113, Regulation (EU) 2024/1689 of the European Parliament and of the Council (EU).

to scale with India's growing digital economy.

Introduction

The traditional architecture of taxation in the international sphere was built on the foundation of "brick and mortar", physically. Under the old and classic 20th-century tax regime, the right of a source state to tax the business profits of a foreign entity was conditional upon the existence of a fixed physical presence or a Permanent Establishment (PE).[3] However, with the meteoric rise of Artificial Intelligence and Software-as-a-Service (SaaS) delivery models in the current world, it has rendered this physical nexus debate obsolete. Today, a generative AI model can process millions of Indian data points, provide complex legal or medical advice, and generate billions in revenue from a server cluster in some foreign country without even a single employee ever setting foot in the Indian subcontinent.

This "borderless" value creation has led to the development of a tug-of-war-like situation between residence-based and source-based taxation. India, as one of the main players in the market, has historically been at the forefront of digital tax innovation, for instance, famously introducing the Equalization Levy in 2016.[4] However, last year India officially repealed this Equalization Levy to align with the OECD's Pillar One global consensus. Yet, this transition has currently created a taxation vacuum. On the one hand, while the Income Tax Act, 2025, which sought to replace the old 1961 act, introduced the concept of virtual Digital Space to modernize the enactment, however, it remains silent on the aspect of how do we tax a mid-tier AI provided that is too small for the global pillar one rules but still too large for India to ignore.[5]

The paper explores this legal fiction of the Virtual Permanent Establishment and the Royalty Trap that characterizes the current AI SaaS licensing. By analyzing the recent updates and judicial precedents, such as the Delhi High Court's rejection of virtual presence in the CIT v Clifford Chance case[6] and also the Supreme Court's expansion of the "disposal test" in the Hyatt International ruling[7], this research brings out a critical question. It further argues that the current binary choice between Business Profit and Royalty is insufficient for the AI era and

[3] AKM GLOBAL, https://www.akmglobal.com/blog/permanent-establishment-india/ (last visited Mar. 10, 2026).
[4] BANGALORE ICAI, https://www.bangaloreicai.org/images/icons/2016/Announcement/16_06_June/2016.06.11_THE%20INCOME%20DECLARATION%20SCHEME-2016.pdf (last visited Mar. 1, 2026).
[5] Income Tax Act, 2025, No. 24, Acts of Parliament, 2025 (India).
[6] CIT v. Clifford Chance Pte Ltd., (2025) 470 ITR 122 (Del).
[7] Hyatt International Southwest Asia Ltd. v. ADIT, (2025) SCC OnLine SC.

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needs to be looked into. Instead, there is a need for a new normative framework that reconciles the Significant Economic Presence rules of the new Act and the traditional constraints of Double Taxation Avoidance Agreements.

The Jurisdictional Hook & Current Stance

The core legal struggle that lies in taxing cross-border AI SaaS is the collision between India's domestic "Significant Economic Presence" rules and the restrictive definition of a Permanent Establishment found in bilateral treaties. Under the legacy regime, India attempted to expand its tax via Explanation 2A to Section 9(1)(i), which introduced a threshold for SEP in the form of Rs 2 crore revenue or 3,00,000 users.[8] Even though the old law tried via explanation but, the new Income Tax Act, 2025 goes further in that direction. The new act has replaced the Business Connection language with a new native Digital Presence framework.[9] Thus, by the introduction of this new framework, the act basically introduces the digital economy into the Indian tax law jurisprudence.[10]

Building on this jurisprudence, the tax department currently follows an aggressive approach. Section 247 of the Income Tax Act, 2025, widens the authorities' power to search and seize information within a "Virtual Digital Space."[11] This section thus ultimately implies that the government has now stopped viewing "the cloud" as a potential barrier. Even though this provision is currently being challenged in the Supreme Court, it still suggests that if an AI algorithm is accessible to the people in India, then it will be considered to be within Indian territory.

This stance of the department, however, faced a judicial roadblock when, in early 2026, in the case of CIT v Clifford Chance Pte Ltd,[12] the High Court delivered a major blow to this Virtual PE theory. The revenue department, however, argues that since services were rendered virtually to the Indian clients for more than 90 days, a "Service PE" existed under the India-Singapore DTAA.[13]

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[8] Income-tax Act, 1961, § 9(1)(i), No. 43, Acts of Parliament, 1961 (India).
[9] CYRIL AMARCHAND MANGALDAS BLOG, https://tax.cyrilamarchandblogs.com/2021/05/cbdt-notifies-thresholds-to-determine-significance-of-significant-economic-presence/ (last visited Mar. 11, 2026).
[10] *Id.*
[11] Income-tax Act, 2025, § 247, No. 24, Acts of Parliament, 2025 (India).
[12] CIT v. Clifford Chance Pte Ltd., (2025) 470 ITR 122 (Del).
[13] India-Singapore Double Taxation Avoidance Agreement (DTAA), art. 5.

The court, however, rejected this and instead held that *"Tax treaties are carefully negotiated instruments…in the absence of an express provision, courts cannot artificially read in a 'virtual presence' where the treaty mandates a physical footprint within a contracting state."*

This ruling creates a high-stakes standoff wherein, on the one hand, the Income Tax Act 2025 provides the domestic authority to tax digital presence, but on the other hand, the Double Taxation Avoidance Agreements, which take precedence under Section 90, remain stuck in the physical world.[14] Domestically, they might have an SEP, but under the treaty, they have nothing. This impasse is the primary driver of the "Royalty Trap," wherein tax officers re-label business profits as royalties to bypass the need for a physical office altogether.

The Characterization Conflict

Wherein, on the one hand, the jurisdictional hook determines where a tax is owed, but on the other, a characterization conflict determines on what a tax is being owed. In the realm of AI SaaS, the Revenue Department's primary method for taxing non-residents whose physical presence is not there is the re-classification of business payments as "Royalties." By this strategy, they aim to bring income under the ambit of Section 9(6)(a) of the Income Tax Act, 2025, which triggers a gross basis Withholding tax (WHT) regardless of whether the provider has an office located in India.[15]

The fundamental problem is that AI is a "black box." In contrast, the Supreme Court's decision in the Engineering Analysis Center of Excellence case[16] largely resolved the issue of traditional software. A "transfer of a copy" is not a part of AI SaaS. The court determined in the Engineering Analysis case[17] that the right to use does not amount to a royalty in the absence of the right to exploit the foundational copyright. In contrast to this ruling, tax departments have been making more and more claims over the past year that AI models, more especially, their neural weights and inference processes, constitute a "Secret Process" or "Commercial Information," which puts them under Explanation 2 of the royalty definition.

The tribunal had to decide whether granting access to a cloud-based algorithmic platform

[14] Income-tax Act, 1961, § 90, No. 43, Acts of Parliament, 1961 (India).
[15] Income-tax Act, 2025, § 9(6), No. 24, Acts of Parliament, 2025 (India).
[16] Engineering Analysis Centre of Excellence P. Ltd. v. CIT, (2021) 432 ITR 471 (SC).
[17] *Id.*

qualifies as a royalty in another case, Dy. CIT v. Trans Union LLC.[18] The revenue claimed that the Indian customer was using the platform's proprietary algorithm. While finding in the taxpayer's favor, the ITAT pointed out that using a process is not the same as accessing a result produced by it. When it comes to AI, this distinction is crucial because when a user prompts a model and receives an output, they have no control over the process that produced it-only the outcome.

Even in the presence of such a ruling, the Income Tax Act 2025 has subtly expanded the scope of this trap. While the new act tries to simplify language, s 9(6)(c) maintains the broad "Explanation 5" and "Explanation 6" from the old Act, which clarify that royalty includes consideration for a process even if the possession or control remains with the provider and the location is outside India.[19] In 2026, the Delhi High Court clarified this further in Amazon Web Services v. ACIT, ruling that while "standard cloud services," such as basic EC2 instances, are profitable for businesses, "specialized AI-API integrations" may still be examined for Fees for Technical Services (FTS).[20]

For AI developers, this development creates a risky "Characterization Gap." Technically, an AI service should fall under business profits if it is judged "too automated" to fall under FTS, which calls for human intervention, and "too opaque" to fall under royalty, which is a process requirement. To avoid a complete loss of tax jurisdiction, the revenue is nevertheless encouraged to include these services in the royalty definition in the absence of a PE.

The Global Transition: Life after the Levy

One of the most significant events in India's fiscal history occurred in April 2025 when the Equalization Levy was repealed.[21] The EL has served as India's unilateral defense against the tax challenge posed by the modern digital economy for nearly ten years. It was first implemented in 2016 as a 6% tax on online ads. In 2020, it was extended to include a 2% tax on e-commerce supplies.[22] The EQ was a *sui generis* tax that was not covered by Double Taxation Avoidance Agreements (DTAAs) and was not included in the Income Tax Act.

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[18] Dy. CIT (Int. Tax) v. Trans Union LLC, (2025) 208 ITAT 512 (Mum).
[19] Income-tax Act, 2025, *supra* note 5, § 9(6).
[20] Amazon Web Services Inc. v. ACIT, (2025) 155 taxmann.com 405 (Del).
[21] TAXMANN, https://www.taxmann.com/research/international-tax/top-story/105010000000026966/indias-digital-tax-reset-the-rise-and-fall-of-equalisation-levy-experts-opinion (last visited Mar. 12, 2026).
[22] TAX AT HAND, https://www.taxathand.com/article/13261/India/2020/Equalization-levy-on-e-commerce-supply-or-services-introduced (last visited Mar. 9, 2026).

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However, in order to fulfill its obligation to the OECD/G20 Inclusive Framework on BEPS,[23] India formally closed this levy following the introduction of the Finance Act, 2025.[24] This action created an unanticipated Pillar One Gap that directly penalizes the growing AI SaaS industry, even though the goal was to promote international cooperation and avoid any retaliatory trade tariffs from the United States.

The central policy failure of early 2026 is the misalignment between the OECD Pillar One (Amount A) thresholds[25] and the reality of the AI market. Pillar One was initially introduced as a bargain strategy so that market jurisdictions like India would scrap their unilateral digital taxes in exchange for being a part of the global residual profits of the world's largest Multi-National Enterprises. However, this approach contained a threshold which was limited to Covered Groups with a global turnover exceeding euro 20 billion and a profitability margin above 10%. For those who don't meet these requirements, particularly mid-tier AI startups, this threshold created a huge "taxation vacuum." Companies like Anthropic, Mistral, or Perplexity, for example, do not meet this threshold despite producing significant economic value and revenue from the Indian market.

Therefore, in exchange for not making any money under the Pillar One formula, India has implicitly given up its right to a steady 2% gross basis tax from these mid-sized AI players by eliminating the Equalization Levy. The Indian Tax Department is now aggressively using domestic "Significant Economic Presence" regulations and Royalty re-characterization under the new Income Tax Act, 2025, to address this problem and fill the void. This change is generally a bad deal for a nonresident AI provider. They paid a clear 2% tax under the previous EL system, which was frequently covered by business expenses. But under the new system, royalties are subject to a 10% gross-basis withholding tax, which raises expenses, increases litigation, and puts them at constant risk of being labeled a "Virtual Permanent Establishment."

Furthermore, this change raises a more serious problem with tax neutrality. The standard corporate tax rate of 25% plus additional surcharges applies to domestic Indian AI startups. However, foreign providers were at least subject to the 2% EL before 2025. Due to the protection afforded by the treaty, a foreign AI SaaS company that is below the Pillar 1 threshold

[23] OECD/G20, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (Oct. 2021/Revised 2025).
[24] Finance Act, 2025, No. 7, Acts of Parliament, 2025 (India).
[25] OECD, Pillar One – Amount A: Draft Multilateral Convention (2025-26 Update).

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and successfully argues based on the Amazon Web Services precedent[26] that its income is Business Profit rather than Royalty may end up paying no tax in India in 2026. Because of this, there is an inherent "Inverted Duty Structure," meaning that it is more tax-efficient for an Indian company to use a foreign AI model rather than a domestic one. If this policy mismatch is not addressed, the domestic AI ecosystem may become hollow just as it is about to enter its most crucial growth phase.

The "life after levy" can therefore be summed up as a paradox in which India has exchanged a straightforward and useful tax for a convoluted legal system that lacks a clear connection to the very technology that is currently the main force behind digital commerce to achieve global consensus through Pillar One.

Critical Analysis

The Indian legislature updated the Income Tax Act, 2025, to be "Digital by Design," but the judiciary is still bound by definitions of physicality and process from the 20th century. This creates a paradox in the current 2026 environment. As a result, there is now a crucial legal deadlock where the laws that are currently in effect are becoming more and more disconnected from the cloud's code.

The most visible evidence of this impasse is the shift in search and seizure powers under section 247 of the Income Tax Act, 2025.[27] Unlike the 1961 Act, which limited the Revenue's power to tangible buildings like buildings, places, or vessels, the new act explicitly encompasses the Virtual Digital Spaces. By defining this space to include cloud servers, remote databases, and encrypted messaging platforms, the legislature has created a statutory bridge between physical jurisdiction and digital reality. However, this raises a profound constitutional question regarding the doctrine of extraterritoriality. For instance, if an Indian tax officer overrides an access code to a server located in Virginia to audit an AI SaaS provider, does this constitute a violation of international sovereignty? As of early 2026, this very issue is pending before the Supreme Court of India, wherein the petitioners argue that Virtual Space cannot be held to be an equivalent of a physical place of business without violating the principles of international comity.[28]

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[26] Amazon Web Services Inc. v. ACIT, (2025) 155 taxmann.com 405 (Del).
[27] Income-tax Act, 2025, *supra* note 5, § 247.
[28] Vishwaprasad Alva v. Union of India, 2026 LLBiz SC 102.

Additionally, the 2026 judicial landscape is defined by the struggle to apply the Disposal Test to the AI infrastructure. In the recent Supreme Court ruling in Hyatt International Southwest Asia Ltd v ADIT (2025)[29], the Court held that "exclusive possession" is not a prerequisite for a Permanent Establishment, instead substantive control and power of disposal over a space are sufficient. When applied to AI SaaS, this precedent creates a difficulty. Tax authorities are now using this Control Test to argue that if a foreign AI firm utilizes dedicated high-performance GPU clusters in an Indian data center, even if they do not own the building, but if they have disposed of that hardware for their business, it thereby creates a Hardware PE. This represents a radical departure from the Engineering Analysis[30] era, moving the focus from copyright to computational nexus.

Critically, this impasse is exacerbated by the Pillar One Exclusion, which has been discussed earlier. Since mid-market AI firms fall outside the Euro 20 billion global revenue safety net, they are subject to being termed as Interpretational Aggression. In the absence of the 2% Equalization Levy, tax officers are reverting to the Royalty Trap with renewed vigor. The recent 2026 case of United India Insurance v CCI,[31] which even though centered on antitrust penalties highlighted a broader judicial trend wherein the courts are becoming wary of the Revenue's attempt to levy interest and penalties retrospectively on impossible choices, however, in the tax context, an AI company faces an "impossible choice" to pay a 10% WHT on royalties and lose competitiveness or claim Business Profit and risk a decade of litigation over a Virtual PE.

This impasse also reveals another significant difficulty in the form of the Algorithmic Transparency conflict. The revenue department under the CBDT's 2026 AI-Enforcement Guidelines has begun using machine learning to nudge taxpayers based on their digital footprints.[32] Ironically, while the government uses AI to enforce taxes, it refuses to recognize the unique nature of AI SaaS as a service, continuing to treat it as a secret process. This double standard of using AI as a sword for enforcement but treating it as a taxable royalty object undermines the Trust-Based Compliance philosophy touted in the Income Tax Act, 2025.

[29] Hyatt International Southwest Asia Ltd. v. ADIT, [2025] 176 taxmann.com 783 (SC).
[30] Engineering Analysis Centre of Excellence P. Ltd. v. CIT, *supra* note 16.
[31] United India Insurance Co. Ltd. v. CCI, (2026) Del HC.
[32] CBDT Guidelines on Machine Learning in Tax Enforcement, Circular No. 04/2026, Acts of Parliament, 2026 (India).

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Ultimately, the 2026 impasse signifies that the source v residence debate is no longer about where a person sits, but instead where the computation happens and where the data is harvested. The failure of current laws to define a Compute-based nexus means that India is currently relying on a patchwork of aggressive audits and stretched legal fictions. Without a clear legislative pivot toward a Digital Characterization Code, the AI sector in India will remain trapped in a cycle of taxation by litigation, hindering the very digital transformation the new act is introduced to support.

Foreign jurisdiction and comparative analysis

In 2026, the Two-Pillar Solution will no longer be pursued by a single nation through the global taxation of AI SaaS. Rather, it has developed into a tri-polar struggle between the United States' defensive Side-by-Side sovereignty, the European Union's regulatory-led taxation, and India's assertiveness at home.

The European Union: Nexus through Regulation

The EU has switched to compliance-linked taxation instead of just fiscal measures. The EU has linked market access to strict risk-based compliance, with the EU AI Act going into full effect on August 2, 2026.[33] Most importantly, a Data Value Nexus is being investigated by the EU. Regardless of the location of the server, the EU contends under the DAC8 Directive that if an AI model is trained using the personal data of EU citizens, the value is harvested within the Union.[34] The EU approach is more focused on taxing the intangible input, the data itself, than India's Significant Economic Presence, which is based on revenue. This establishes a secondary tax layer where punitive levies that serve as a de facto digital services tax can be imposed for noncompliance with AI safety standards.

The United States and the Side-by-Side Defense

The US is one of the main defenders of its titans, including OpenAI and Anthropic, and adheres to the Physical PE rule. A side-by-side package that brought the US tax system into compliance with Pillar Two was released by the OECD in January 2026.[35] In addition to exempting US businesses from the foreign top-up taxes, this administrative agreement permits the US to keep

[33] EU AI Act, *supra* note 2.
[34] OECD, Directive on Administrative Cooperation (DAC8) (Digital Assets and Services), (2026).
[35] U.S. Internal Revenue Service (IRS), Notice 2026-01: Guidance on Global Minimum Tax and Pillar Two Compliance (U.S.).

its Global Intangible Low-Taxed Income Regime. This presents a significant obstacle in the Indian context since the US views AI SaaS as a business profit, but India attempts to tax it as a royalty. This disparity in description basically means that US businesses frequently are unable to claim a foreign tax credit for taxes paid in India, which ultimately results in trade friction and double taxation.

Brazil

Brazil took a different course, while India eliminated its Equalization Levy. Brazil began implementing a dual VAT system in 2016, requiring AI providers without a PE to register locally and collect tax at the user's location.[36] Compared to the more complicated Indian Virtual PE litigation, this registration-based nexus is less complicated. This shift implies that, rather than attempting to force-fit the current digital algorithms to Income Tax definitions from the previous century, the world may be heading toward a consumption-based tax model for AI.

Recommendations to tackle this impasse

The Royalty Trap and Pillar One Gap define the legal problem in India's 2026 tax jurisprudence, necessitating a fundamental change from reactive litigation to proactive codification. This paper suggests a pillarized reform strategy intended to provide tax certainty while simultaneously safeguarding India's sovereign right to tax digital value in order to address the conflict between the Income Tax Act, 2025, and the borderless nature of AI SaaS.

The AI Inference Safe Harbor by Legislative Intervention

The most immediate cause of action in the form of litigation is the ambiguity surrounding whether an AI API call constitutes a Royalty for a secret process or a Business Profit. The Central Board of Direct Tax should create a Presumptive Taxation Regime for Algorithmic Services by adding a new section to the most recent act to address this.

This AI safe harbor would enable foreign AI providers who do not meet Pillar One's Euro 20 billion threshold to choose to pay a flat 5% tax on gross Indian receipts, much like the current section 44BB for the oil and gas industry.[37] They would receive a deemed No-PE status in return, and the income would no longer be able to be classified as a royalty. In addition to giving the Indian Treasury immediate, non-litigious revenue, this opt-in model gives AI

[36] EDICOM, https://edicomgroup.com/blog/brazil-tax-reform (last visited Mar. 7, 2026).
[37] Income-tax Act, 2025, § 44BB, No. 24, Acts of Parliament, 2025 (India).

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startups some tax certainty, which is necessary for them to grow in the Indian market without worrying about ten-year Virtual PE assessments.

Codifying the Compute-Nexus Rule

The case of Hyatt International[38] shows that the Disposal Test is now also being used to test cloud infrastructure. To stop any unfair evaluations, the Income Tax Act of 2025 needs to be changed to include a Functional Control Threshold for Data Centers.

The main point of the recommendation is to make a clear difference between a Public Cloud and a Dedicated Compute. For example, if a non-resident AI company only uses shared resources like standard AWS Lambda or Azure instances, these companies should not be considered Permanent Establishment. If the company, on the other hand, rents Dedicated GPU Clusters for more than 180 days and has full control over how they work, then a Hardware PE should be recognized. India can update its nexus rule by linking the Virtual PE to certain high-value hardware. This is in line with the spirit of international tax treaties that require a mandatory fixed presence.

The Digital Input Tax Credit

One of the biggest problems with the time after the Equalization Levy is the inverted Neutrality. This means that foreign AI companies can pay 0% tax under treaty protection, but Indian AI startups have to pay 25% unless granted specific exemption. The government should create a Digital Innovation Credit to make things fairer.

This system should let any Indian business that pays a withholding tax (WHT) on foreign AI SaaS subscriptions claim a 150% weighted deduction of that tax against their own domestic output tax liability. The government could also give Indian AI startups a Tax Equalization Offset, which would let them deduct some of their research and development costs directly from their corporate tax bill. This would bring their tax rate down to the same level as that of their foreign competitors. This makes sure that the Indian AI ecosystem stays competitive and doesn’t get taxed out of existence by its own country.

Clarification on the Secret Process for Gen-AI

The judiciary is currently struggling with whether “neural weights” are a process. This paper recommends a Legislative clarification in the new act. This clarification should explicitly

[38] Hyatt International Southwest Asia Ltd. v. ADIT, (2025) SCC OnLine SC 4122.

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clarify the confusion regarding the process, which can be resolved by stating that "the mere utilization of an autonomous algorithmic output, where the user does not acquire the right to modify, redistribute, or reverse-engineer the underlying source code or weights shall not constitute the use of a secret process or royalty." The consumer-output rule would also align Indian law with the Supreme Court's logic in the Engineering Analysis case[39] while specifically addressing the Black Box nature of Generative AI. It prevents tax officers from looking under the hood of every API call to find a taxable royalty, thereby reducing the compliance burden on both the state and the taxpayer.

Bilateral AI protocols

Finally, while Pillar One addresses the big players in the realm of tech, India should lead the way in creating Bilateral annexes for the small players. India should propose a protocol amendment to its DTAAs with major AI hubs such as the US, Singapore, and Ireland. This amendment would propose a definition of a unified Digital Service Rate for firms that fall out of Pillar One, and will ultimately prevent the current situation where a company is taxed at 10%, but they cannot get a tax credit in their home country since the US refuses to recognize the Royalty Characterization.[40]

India can switch from taxing people through lawsuits to taxing people based on a design framework by following these extra suggestions. These changes would not only keep India's promises to the world, like Pillar One, but they would also make sure that the Income Tax Act of 2025 helps the Indian economy move toward an AI-driven future instead of getting in the way.

Contractual Safeguards: Drafting for the risk

In today's legal system, writing cross-border AI licensing agreements is no longer just about protecting intellectual property. It has also become more complicated and includes tax risk allocation. The main goal of a non-resident AI provider is to stay safe from the Royalty Trap and the new Hardware PE risks. So, for these reasons, some points can be added to move in this direction.

First, the Gross Up and Indemnity clauses are no longer open to negotiation. Because the

[39] Engineering Analysis Centre of Excellence P. Ltd. v. CIT, *supra* note 16.
[40] LEXOLOGY, https://www.lexology.com/library/detail.aspx?g=56ada977-67c8-46e1-8dc8-be1fc31cba44 (last visited Mar. 5, 2026).

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revenue is pushing hard to change AI inference calls into royalties, more and more providers are requiring that all payments be made without taxes. But according to the New Act, this act of grossing up can make things much more expensive for Indian licensees. To avoid this, the practitioners should add Tax Representation and Warranty clauses. These clauses state that the Indian licensee is using the AI service as a standard automated service instead of a custom process. This will protect them in future audits.

Secondly, to resolve the Compute Nexus risk, the contract should include Physicality Disclaimers. Since the issue lies in the power of exclusive control, these clauses will explicitly state that the AI provider has no power of disposal or exclusive control over the servers or GPU clusters used to deliver the service. This will help them to respond to the Hyatt International strategic control test.[41]

Finally, the Change in Law provisions have been broadened to account for the sunset of the Equalization Levy and the potential introduction of Digital Presence surcharges. These safeguards ensure that if the characterization of an AI API shifts from business profit to royalty mid-term, the financial burden is transparently allocated, preventing the impossible choice of retrospective liability.

Conclusion

The taxation of cross-border AI SaaS in 2026 represents the ultimate and important test for India's fiscal sovereignty. As physicality dissolves the Virtual Digital Space, the traditional reliance on Permanent Establishment and the Secret Process doctrine has reached a breaking point. This paper has demonstrated that the repeal of the Equalization Levy and the emergence of the Pillar One Gap have left mid-tier AI innovators in a precarious Taxation by Litigation cycle.

The path forward requires legislative intervention by transitioning from the archaic 20th-century definitions to a Digital Tax-friendly legislation. By implementing the proposed AI inference Safe Harbor and codifying a compute-based Nexus, India can harmonize its domestic goals with international consensus. The Income Tax Act, 2025, must be interpreted not as a tool for aggressive re-characterization but as a framework for tax neutrality, ultimately for India to lead

[41] Hyatt International Southwest Asia Ltd. v. ADIT, (2025) SCC OnLine SC.

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the global AI revolution, its tax laws must be as innovative as the algorithm seeks to govern.