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Taxation of Virtual Digital Assets

Meyyappan N

Vibhore Batwara

March 2024

Draft for discussion purposes only

Business Models

- Exchanges
  - Indian / international
  - Centralized / decentralized
- Brokers
- Gaming – player cards as NFTs
- Employee Incentive
- Minting of tokens
- Wallet / custody services
- Crypto funds and investment professionals
- NFT marketplace
- DeFi
- Real asset tokenization
- Others (e.g., social media, music, content creation)

Regulatory Regime

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October 2008
A paper titled "Bitcoin: A Peer to Peer Electronic Cash System" in was published by a pseudonymous developer by the name of Satoshi Nakamoto. On January 3, 2009, first bitcoin was mined.

December 2013
The RBI issued a circular warning users of the potential risks (security, no central agency, security, no inherent value, legal status and usage in illicit activities) pertaining to the use of virtual currencies (**VC**)

Feb 2017
The RBI clarified that it has not given any approval to any entity to operate schemes or deal with any VC. Further, it cautioned that any user, holder, investor, trader, etc. dealing with VCs will be doing so at their own risk.

December 2017
In the wake of significant spurt in the valuation of many VCs and rapid growth in Initial Coin Offerings (ICOs), RBI reiterated the concerns conveyed in the earlier press releases.

April 2018
RBI imposed a ban on entities regulated by it to not deal with VCs or provide services for facilitating any person or entity in dealing with or settling VCs.

July 2019
An Inter-Ministerial Committee established by the Ministry of Finance released a report on a proposed regulatory approach towards distributed ledger technology and VCs. The Committee recommended an outright prohibition, along with criminal penalties, on dealing with VCs.

March 2020
The SCI set aside, on constitutional grounds, April 2018 circular issued by the RBI. This affirmed virtual currency exchanges' fundamental right to trade and do business, guaranteed under the Constitution of India.

April 2022
A new income tax regime was introduced for virtual digital assets (VDAs) which included definition of VDAs, Taxation of income from the transfer of VDAs, Gift tax on VDAs, and withholding obligation on transfer of VDAs.

March 2023
The Ministry of Finance extended the applicability of certain compliance obligations under the PMLA Act to various service providers in the virtual digital asset ecosystem.

Regulatory: PMLA Applicability

MINISTRY OF FINANCE

(Department of Revenue)

NOTIFICATION

New Delhi, the 7th March, 2023

S.O. 1072(E).—In exercise of the powers conferred by sub-clause (vi) of clause (sa) of sub-section (1) of section 2 of the Prevention of Money-laundering Act, 2002 (15 of 2003) (hereinafter referred to the as the Act), the Central Government hereby notifies that the following activities when carried out for or on behalf of another natural or legal person in the course of business as an activity for the purposes of said sub sub-clause, namely:-

(i) exchange between virtual digital assets and fiat currencies;

(ii) exchange between one or more forms of virtual digital assets;

(iii) transfer of virtual digital assets;

(iv) safekeeping or administration of virtual digital assets or instruments enabling control over virtual digital assets; and

(v) participation in and provision of financial services related to an issuer's offer and sale of a virtual digital asset.

Explanation:- For the purposes of this notification "virtual digital asset" shall have the same meaning assigned to it in clause (47A) of section 2 of the Income-tax Act, 1961 (43 of 1961).

Definition of VDAs

The Finance Act, 2022 has defined VDA under section 2(47A) of the ITA.

2(47A) states :-

(a) any information or code or number or token (not being Indian currency or foreign currency), generated through cryptographic means or otherwise, by whatever name called, providing a digital representation of value exchanged with or without consideration, with the promise or representation of having inherent value, or functions as a store of value or a unit of account including its use in any financial transaction or investment, but not limited to investment scheme; and can be transferred, stored or traded electronically;
(b) a non-fungible token or any other token of similar nature, by whatever name called;
(c) any other digital asset, as the Central Government may, by notification in the Official Gazette specify:
Provided that the Central Government may, by notification in the Official Gazette, exclude any digital asset from the definition of virtual digital asset subject to such conditions as may be specified therein.

Explanation: For the purposes of this clause,-
(a) “non-fungible token” means such digital asset as the Central Government may, by notification in the Official Gazette, specify;
(b) the expressions “currency”, “foreign currency” and “Indian currency” shall have the same meanings as respectively assigned to them in clauses (h), (m) and (q) of section 2 of the Foreign Exchange Management Act, 1999 (42 of 1999).

Definition of VDAs: Dissection

Necessary Criteria	Additional Criteria	Exclusions
▪ any information or code or number or token, ▪ generated through cryptographic means or otherwise, ▪ can be transferred, stored or traded electronically;	• providing a digital representation of value exchanged with or without consideration, with the promise or representation of having inherent value, or • functions as a store of value or a unit of account (including its use in any financial transaction or investment, but not limited to investment scheme);	Indian currency or foreign currency as defined under Foreign Exchange Management Act, 1999 is excluded from the ambit of VDA meaning that anything that is Indian currency or foreign currency is automatically not a VDA. Further, Central Government has power to notify in the Official Gazette to exclude any digital asset from the definition of virtual digital asset subject to such conditions as may be specified therein.

(2) NFT: The definition of VDA also specifically includes a non-fungible token ("NFT") or any other token of similar nature, by whatever name called; and
(3) any other digital asset, as the Central Government may, by notification in the Official Gazette specify

Definition of VDAs: Key Considerations

- Expansive scope:
  - ‘information’, ‘code’, ‘number’ makes the definition of VDA all encompassing
  - generated through cryptographic means **or otherwise**
  - Coverage of other assets - credit card / debit card reward points, airline miles, digital vouchers, in-game currencies, dematerialised securities etc.
  - Crypto Futures – ticking bomb?

- Inherent value
  - ‘..promise or representation of having inherent value…’
  - Inherent value not necessary at time of issuance – reference to offer documents

- Non-exclusion of securities – already defined and taxable for the purpose of ITA

Definition of VDAs: Key Considerations

Exclusions through Notifications:

Notification no. 74 of 2022

- Gift cards or vouchers, being a record that may be used to obtain goods or services or a discount on goods or services
- Mileage points, reward points, loyalty cards, being a record (i) given without direct monetary consideration under an award, reward, benefit, loyalty, incentive, rebate or promotional programme (ii) that may be used or redeemed **only** to obtain goods or services or a discount on goods or services
- Subscriptions to websites or platforms or applications.

Notification no. 75 of 2022

- Transfer of NFTs – two transfers?
- An NFT whose transfer results in transfer of ownership of underlying tangible asset and the transfer of ownership of such **underlying tangible asset** is legally enforceable is excluded from the scope of NFT.

Taxing income from transfer of VDAs under section 115BBH

Tax Rate	• Special tax rate of 30% (exclusive of surcharge and cess) applicable
Computation	• Income to be computed without taking effect of: • Any deduction in respect of any expenditure (other than cost of acquisition) incurred for such transfer; or • Any allowance or set off of any loss.
Inter-head set off	• Loss from transfer of VDAs shall not be permitted to be set off against income computed under any other head under the ITA. The loss shall not be allowed to be carried forward to succeeding assessment years as well.
Characterisation	• Characterisation should not matter as no deductions or set off or carry forward of losses are permitted under section 115BBH. Treaty Benefits? • ITR forms provide that income from transfer of VDAs can either be business income / capital gains. Hence, puts an end to characterisation issues under the ITA.

Schedule VDA

ITR-6 , Income-tax Rules, 1962

37 of 62 180%

Schedule VDA	**Income from transfer of Virtual Digital Assets (Note: Details of every transaction are to be filled, wherein every 'transfer' is a transaction)**					
Sl. No.	Date of Acquisition	Date of Transfer	Head under which income to be taxed (Business/Capital Gain)	Cost of Acquisition (In case of gift; a. Enter the amount on which tax is paid u/s 56(2)(x) if any b. In any other case cost to previous owner)	Consideration Received	Income from transfer of Virtual Digital Assets (enter nil in case of loss) (Col. 6 – Col. 5)
(Col. 1)	(Col. 2)	(Col. 3)	(Col. 4)	(Col. 5)	(Col. 6)	(Col. 7)
Add Rows						
A.	**Total (Sum of all Positive Incomes of Business Income in Col. 7)**					**(Item No. 3f of Schedule BP)**
B.	**Total (Sum of all Positive Incomes of Capital Gain in Col. 7)**					**(Item No. C2 of Schedule CG)**

Key Issues:

- Levy of tax on transaction basis? Intent of the provisions.
- If two transfers in same VDA take place on the same date, can they both be clubbed and reported in Schedule VDA?
- When a VDA market sale order is placed and is executed in 7 different fractions, should each fraction be individually reported?
- Can inter-VDA trades be clubbed? Difference from shares. Loss set off can happen in such situation
- Conundrum on date of transfer being prior to date of acquisition – short sellers.

Withholding Obligation

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- Section 194S of the ITA obligates "any person responsible for paying to a **resident** any sum by way of consideration for transfer of a VDA to withhold tax at rate of 1% at the time of payment or credit, whichever is earlier.
  - High rate of tax? Comparison with STT, other transaction based levies
  - Capital stuck for users on rotation – issue for high frequency traders, liquidity providers
- The Direct tax collected by way of tax deducted at source under section 194S of the Income-tax Act, 1961, on payments made upon transfer of VDA aggregates to **Rs. 157.9 crore upto 20-3-2023** (from July 1, 2022) for FY 2022-23.
- Withholding liability under Section 194S is applicable when the payment for the transfer of VDA exceeds
  - INR 50,000 during the financial year in the case of a specified person; and
  - INR 10,000 in other cases.
- In case consideration is payable in kind on transfer of VDA, the person responsible for paying should, before release of the consideration, ensure that tax required to be deducted has been paid in respect of such consideration for the transfer of VDA.
  - VDA to VDA trades quite common
  - In case VDA accepted as consideration for performance of service?
  - Buyer may release the consideration in kind after seller provides proof of payment of such tax (e.g. challan details etc.) or Buyer may deposit such tax on behalf of seller.

Withholding Obligation

- Crypto sale on exchange – who is person responsible for paying?
  - Difference between payer and remitter - Uber India Systems (P.) Ltd. [2021] 125 taxmann.com 185 – Uber India was mere remitter and not payer in respect of commission paid to the drivers on behalf of Uber BV
  - Issue with buyer not able to identify the counter party
  - Circular 13 of 2022 – "*To remove this difficulty, it is clarified that while the primary responsibility to deduct tax under section 194S of the Act, in this case, remains with the buyer or his broker, as an alternative the Exchange may enter into a written agreement with the buyer or his broker that in regard to all such transactions the Exchange would be paying the tax on or before the due date for that quarter.*"
  - Definition of exchange: "*The term "Exchange" means any person that operates an application or platform for transferring of VDAs, which matches buy and sell trades and executes the same on its application or platform.*" – Peer to peer marketplace?
- Interplay with other withholding tax provisions under the ITA
  - Section 194S specifically contains a non-obstante clause (section 194S(4)) to provide that if tax is deductible under 194S and 194O, then tax shall be deductible under 194S. However, no exclusion provided that tax shall not be deductible under 194O.
  - 194Q – Circular 14 of 2022 - "*Without going into the merit whether VDA is goods or not, it is clarified that once tax is deducted under section 194S of the Act, tax would not be required to be deducted under section 194Q of the Act.*"
  - Deletion of sub-section (4) under the Finance Act, 2022 – "*(4) Notwithstanding anything contained in this Chapter, a transaction in respect of which tax has been deducted under sub-section (1) shall not be liable to deduction or collection of tax at source under any other provisions of this Chapter.*"

Gift Tax

- Section 56(2)(x) is an anti-abuse provisions which deems income in the hands of the recipient, if any (i) sum of money, (ii) immovable property, or (iii) any property (other than an immovable property) is received by such recipient (i) without consideration and the fair market value ("FMV") of the property exceeds INR 50,000 or (ii) for a consideration which is less than aggregate FMV of the property by an amount exceeding INR 50,000.
- 'Property' has been defined under explanation to section 56(2)(x) of the ITA read with sub-clause (d) to the explanation to section 56(2)(vii) as ""property" means the following capital asset of the assessee, namely:- (i) immovable property being land or building or both; (ii) shares and securities; (iii) jewellery….". VDAs also included in definition of 'property'.
- Certain exemptions: receipt of property
  1. from a relative,
  2. under will or inheritance,
  3. from any trust or charitable institution registered under ITA, etc.
- Airdrops: Can a view be taken airdropped tokens have been received because use of a particular VDA's ecosystem, for which the taxpayer may have incurred certain transaction cost as well, and hence the VDA has not been received without consideration.

GST Characterisation

- Currently no guidance on the manner in which GST provisions are applicable to transactions in VDAs.
- GST is a levy on supply of goods or services
- Definition of goods under GST – Section 2(52) of CGST Act:
  - *"**every kind of movable property** other than money and securities but includes actionable claim, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before supply or under a contract of supply"*
- Meaning of property - *Therefore, the word **'property' connotes** everything which is **subject of ownership, corporeal or incorporeal, tangible or intangible, visible or invisible, real or personal**; everything that **has an exchangeable value**, or which goes to make up wealth or estate or status*
- Foreign case laws –
  - UK - Robertson v Persons Unknown (unreported, CL-2019-000444) – fraud protection
  - UK - AA v Persons Unknown [2019] EWHC 3556 (Comm) – interim proprietary injunction
  - New Zealand – Cryptopia – VDAs are property which are capable of being held in trust
  - Singapore - ByBit Fintech Ltd v Ho Kai Xin and others [2023] SGHC 199 – USDT is a property
- VDAs have been considered 'property' for the purpose of gift tax. Further, income from transfer of VDA can also be characterised as capital gains.
  - Definition of capital assets – "*"capital asset" means—*

  *(a) **property of any kind** held by an assessee, whether or not connected with his business or profession;*",

GST Characterisation

- In June 2022, during the 47th GST Council Meeting, it was noted that the Fitment Committee felt that there is a need to "identify all relevant supplies associated with crypto-ecosystem which are under the ambit of GST; their nature whether those activities are goods or services; their applicable rate based on appropriate classification". The issue was further deferred in the 48th GST Council Meeting held in December 2022.
- Implications?

Other Key Considerations

- Situs of VDA
  - No special rules prescribed under law
  - Situs of intangible property
    - CUB Pty Ltd. v. UOI [2016] 71 taxmann.com 315 (Delhi) – "*The situs of the owner of an intangible asset would be the closest approximation of the situs of an intangible asset. This is an internationally accepted rule, unless it is altered by local legislation.*"
    - Lal Products v. Intelligence Officer, 2018 SCC OnLine Ker 5304 – "We are in respectful agreement with the aforesaid decision that the situs of the owner of an intangible asset, would be the closest approximation of the situs of an intangible asset."

- Disclosure in Schedule FA – is it a foreign asset i.e. is it an asset located outside India?

- FEMA
  - General rule – cross border barter is not permissible, consideration should flow through authorized banking channels
  - Investment outside India
    - LRS - no change in assets or liabilities outside India – current account – limit of USD 250000
    - Restriction from banks
    - ODI - Investment in financial services activity?

Key Commercial Applications and Implications

- Offshore Structures for Minting, Global Platforms – POEM?
  - INR 50 crore threshold

- Gaming integration
  - Minting usually outside India – how to determine cost of acquisition?
  - Ring fencing for Indian users
  - Interplay with 194O

- Employee incentive
  - Receiving VDAs from the offshore company – cross border barter – will attract FEMA
  - Receiving VDAs directly from the protocol as first owners – no movement in / outside India, 56(2)(x), cost of acquisition?
  - Phantom options – bonus income – no VDA element

- Real world tokenization
  - Transfer of token results in transfer of underlying property?
  - NFT exemption applicable in case of tangible property only

References

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