

Tax Hotline

July 08, 2022

TAXATION OF CRYPTO-ASSETS

Emerging regime for Virtual Digital Assets (VDAs)

- CBDT clarifies the obligation of Exchanges with respect to withholding tax under section 194S
- Mechanism for conversion of tax withheld in VDA to fiat provided
- Gift card or vouchers, reward points, airline miles etc. not in the scope of VDA
- Where underlying tangible property is simultaneously transferred through transfer of NFT, such NFT excluded from scope of VDA

The Income-tax Act, 1961 ("ITA") did not contain any specific provisions for taxation of virtual digital assets ("VDA") until the Finance Act, 2022 ("FA 2022") (coming into effect from April 1, 2022). The Finance Act, 2022 has introduced the much-awaited taxation regime for VDAs in India. Specifically, FA 2022 introduced the following:

- Section 2(47A): An expansive definition for VDA;
- Section 115BBH: Taxation of income from the transfer of VDAs at the rate of 30%;
- Section 56(2)(vii) & (x): Gift tax on VDAs - definition of 'property' expanded to include VDAs;
- Section 194S: Withholding tax ("WHT") provision on payment of consideration for the transfer of VDAs to residents.

Our in-depth analysis of the above-mentioned provisions at the time of their proposal through the Finance Bill of 2022, can be found [here](#). Since then, certain changes were brought about in the provisions of the Finance Bill, through FA 2022, and more recently, the Central Board of Direct Taxes ("CBDT"), and the Ministry of Finance ("MoF") released a set of circulars and notifications to clarify the operability of the withholding provisions, the procedure for compliance, clarification on scope of VDAs etc.

In this hotline, we discuss and analyze the circulars/ notifications issued by CBDT.

1. WITHHOLDING ON VDA TRANSACTIONS THROUGH EXCHANGE [CIRCULAR NO 13 OF 2022] ("CIRCULAR 1"):

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 the rate of 1% at the time of payment or credit, to the account of the resident, whichever is earlier. Section 204 of the ITA defines the person responsible for paying to mean (i) in case of residents, the payer of the sum (or principal officer, in case of a company) and (ii) in case of non-residents, the person himself or any person authorized by the non-resident. In *Uber India Systems (P.) Ltd.*¹, the Income Tax Appellate Tribunal ("ITAT") highlighted the distinction between payer and remitter and held that Uber India Systems Private Limited was not the payer, and consequently not the person responsible for paying.

Given the above, in case where an intermediary (like a cryptocurrency exchange) is facilitating transfer of VDAs on its platform, it was not clear whether such intermediary could be held liable to withhold tax under section 194S.² To remove such ambiguities, Circular 1 clarifies who would be liable to withhold tax under section 194S in case where VDA transactions take place through an Exchange³ or Broker⁴ (as defined therein).

The table below summarizes the clarification provided by Circular 1 with respect to the person responsible for withholding tax under section 194S.

S No	Consideration	Platform Model	Broker	Obligation to deduct tax
1.	Where consideration for the transfer is paid in fiat currencies	Exchange Model VDA (owned by another user/ Broker) transferred on the Exchange. The buyer and seller	No broker involved Broker involved, where the broker holds title to the VDA (i.e. the broker is the	Tax to be deducted by the Exchange on the payment made to the seller (i.e. the owner of the VDA) Tax to be deducted by the Exchange on payment made to the Broker

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places orders on seller) the Exchange platform. The Exchange matches and executes the order and earns in lieu of commission /service fee.

Broker involved, where the broker does not hold title to the VDA (i.e., the Broker is not the seller)

Obligation to deduct tax falls on both:

- (a) the Exchange, and
- (b) the Broker.

However, Circular 1 provides that if there is a written agreement between the Exchange and the Broker that Broker shall be deducting tax, then Broker may deduct the tax under section 194S

The Exchange will however need to furnish a quarterly statement for all such transactions in the quarter within the prescribed forms and due dates.

OTC Model

VDA (owned by Exchange) are transferred on the Exchange. The Exchange is the counterparty to such transactions and maintains its own repository of VDAs and conducts back-to-back transactions with the users.

No Broker involved

Broker involved, however, the Broker does not hold title to the VDA (i.e. the broker is not the seller)

Primary obligation to deduct taxes is on the buyer or their Broker (as the case may be). However, Circular 1 provides an alternative wherein the Exchange may enter into a written agreement with the buyer or their Brokers stating that the Exchange would be paying taxes.

The Exchanges would be required to furnish quarterly statements for all such transactions. It will also be required to furnish its income tax return and include such transactions therein. Circular 1 provides that if these conditions are complied with, the buyer or his Broker would not be held as assessee in default under section 201 of the ITA for these transactions.

Circular 1 also clarifies that in case of transactions where consideration for transfer of VDA is paid in exchange of another VDA, the Exchange would be required to withhold tax on both legs of the transaction. The buyer and seller would not be independently required to follow the procedure provided in proviso to section 194S(1).

It is important to note that Circular 1 has been issued under section 194S(6) read with section 194S(7) of the ITA. Therefore, Circular 1 is binding on the tax authorities and the person responsible for paying.

Our comments: The clarification provided by Circular 1 puts an end to confusion and extent of Exchange's liability to comply with section 194S. Circular 1 defines Exchanges for the first time with respect to the ITA. Given the different type of models, the definition of Exchange should provide clarity to market participants regarding obligation to withhold tax under section 194S. The compliance burden has been shifted from the users to the Exchange in most cases. Circular 1 also seems to have nailed several practical issues faced by the industry and provide feasible solutions. For example, it recognizes that there may be situations wherein tax deducted in kind may need to be converted into cash for depositing to the Government. In this regard, Circular 1 provides mechanism for tax deducted in kind into cash. The mechanism provided by Circular 1 is likely to increase the compliance burden on the Exchanges (with the Exchanges required to maintain trail of transactions, time stamping of order etc.). Further, the mechanism for accumulation of tax deducted in form of primary VDAs till end of the day and conversion into cash at midnight may provide opportunities to participants to engage in price play. This will need to be carefully monitored by Exchanges as well. In a welcome move, Circular 1 has also clarified that there will be no further withholding on conversion of tax withheld in kind into INR.

2. WITHHOLDING ON TRANSACTIONS NOT COVERED UNDER CIRCULAR 1 [CIRCULAR NO 14 OF 2022] ("CIRCULAR 2"):

Circular 2 (except question 6) is applicable on all transactions not covered by Circular 1 i.e. transactions in relation to transfer of VDA not on or through an Exchange. Circular 2 *inter-alia* clarifies the liability to withhold tax in the following situations:

- **When the consideration is paid in fiat:** In peer to peer transaction (i.e. buyer to seller without going through an Exchange), the buyer (i.e. person paying the consideration) is required to deduct tax under section 194S of the ITA. The tax base for withholding is consideration for transfer of VDA as reduced by goods and service tax ("GST").
- **When the consideration is paid in kind:** In such a case, the person responsible for paying such consideration is required to ensure that tax required to be deducted has been paid in respect of such consideration, before releasing the consideration. Thus, the buyer will release the consideration in kind after seller provides proof of payment of such tax (e.g. challan details etc.).
- **When consideration is paid in exchange of another VDA:** In such a case, both the buyer and seller need to pay tax with respect to the individual transfer of VDAs. Once tax is paid, both the buyer and seller are required to show evidence to the other person so that the VDAs can be exchanged.

Without going into the merits of whether VDA is a good or not, Circular 2 also clarifies that once tax is deducted under section 194S, tax would not be required to be deducted under section 194 Q (withholding on purchase of goods).

Our comments: At the outset, it is important to note that unlike the guidelines issued Circular 1, Circular 2 has been issued under section 119 of the ITA. Therefore, while Circular 1 is binding on the tax authorities and the person responsible for paying, it may be possible to argue that Circular 2 is binding only on the tax authorities, and **not** on the taxpayers.⁵ Having said this, it is not clear why Circular 2 was also not issued under section 194S(6).

As discussed above, Circular 2 is applicable only on transactions not falling in the ambit of Circular 1. Therefore, in cases where VDA transactions are not happening through an Exchange, withholding under section 194S should be done in accordance with Circular 2. Further, while Circular 2 clarifies that tax base for withholding will be reduced by GST, applicability of GST on VDAs is not clear. There have been news reports suggesting that Indian government is working on characterization of crypto-assets for the purpose of GST laws.⁶

3. OTHER CLARIFICATORY UPDATES:

The CBDT also issued 2 other notifications, shedding further colour to the tax regime of VDA:

a. **Exclusions from the definition of VDA** [CBDT Notification dated June 30, 2022] ("Notification 3"):

Owing to the significantly wide definition of VDAs introduced through FA 2022, there was a lack of clarity as to whether airline reward points, credit card points, gift cards, etc. would also fall within the definition of VDAs. The Notification 3 excludes the following VDAs from the definition of VDAs:

- 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 program (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.

Our comments: While the exclusions notified by the CBDT are welcome, it is important to note that the CBDT has worded the aforesaid notification in a narrow manner. The Notification 3 makes it clear that the items excluded earlier fell under the definition of VDAs. Having said this, it is important that emphasis is given to the exact language of the notification to determine whether the exclusion is applicable in case of a particular VDA or not. For example, in case where reward points are issued to users two conditions have to be satisfied for being excluded from the definition of VDAs – (i) the reward points should be given to the user without any direct monetary consideration under an award / reward program, and (ii) the reward point may be redeemed only to obtain goods or services or discount on goods or services. Therefore, in case where reward points can be used to obtain other cryptocurrencies or native / non-native tokens, it may not fall under the ambit of the exclusion depending on whether such cryptocurrencies or native / non-native tokens can be said to be 'goods' or 'services'. Similar issues may arise in case where reward points may be redeemed to obtain a voucher. Pertinent to note that both Circular 1 and Circular 2 do not clarify whether VDAs will be characterized as goods for tax purposes or not. Same condition will have to be checked for gift cards or vouchers to qualify for the exclusion. Further, it is unclear why 'subscriptions to websites or platforms or applications' were required to be excluded from the definition of VDAs.

b. **Clarification with respect to the scope of Non-Fungible Tokens ("NFT")** [CBDT Notification dated June 30, 2022] ("Notification 4"):

NFTs are specifically included within the scope of VDA as a separate category. Notification 4 specifies that a token which qualifies as a VDA is an NFT within the ITA. However, 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.

Our comments: The clarification provided under Notification 4 is welcome. NFTs generally represent a unique and existing physical or virtual goods, service or asset (e.g. artwork, music, real estate property etc.). It was not clear whether the tax department may view sale of an NFT as combination of two transactions – (1) sale of NFT itself, and (2) sale of the underlying property / asset represented by NFT. The clarification under Notification 4 should exclude cases where physical assets like land, painting etc. are tokenized and transferred through NFTs. Such NFT through which land or part of land is transferred and the ownership in the underlying land is also transferred will be excluded from the scope of VDAs. The sale of land will be taxable as per the usual provisions of the ITA and the VDA regime should not be applicable. This may give a boost to tokenization of physical assets. It is important to note that the Notification 4 covers only NFTs whose transfer results in transfer of ownership of underlying *tangible* (physical) assets. While practically ownership in underlying intangible assets (like music, video clip etc.) may not be transferred through NFTs, it will be important to closely examine the tax implications of such transactions as well.

CONCLUSION

The aforesaid clarifications, though last minute, have been welcomed by the industry participants. Several crypt-exchanges have implemented procedures to give effect and operationalize withholding from July 1, 2022. While the clarifications are technically applicable on foreign exchanges as well, foreign exchanges are likely to face more challenges in operationalizing withholding mechanism.

Having said this, the tax regime for VDAs is likely to evolve further in future. There are a number of open issues which continue to remain present. Currently, there are no guidelines on valuation of VDAs. This will be essential for determining tax base from income-tax and GST perspective. Valuation of VDAs may be particularly challenging given the volatility of the crypto-market. Lastly, the decision with respect to applicability of GST on VDAs may define the course of this industry in India.

– Arijit Ghosh & Ipsita Agarwalla

You can direct your queries or comments to the authors

¹ Uber India Systems (P.) Ltd. vs. Joint Commissioner of Income Tax, [2021] 125 taxmann.com 185 (Mumbai - Trib.)

² <https://www.theweek.in/news/biz-tech/2022/02/07/why-crypto-players-are-confused-about-new-tax-rules.html>

³ '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 The definition is wide enough to cover both models of exchanges typically seen in the marketplace

⁴ Broker” means any person that operates an application or platform for transferring of VDAs and holds brokerage account/accounts with an Exchange for execution of such trades

⁵ See Navnit Lal C. Javeri vs. K.K. Sen, Appellate Assistant Commissioner of Income-tax, [1965] 56 ITR 198 (SC), Catholic Syrian Bank Ltd. vs. Commissioner of Income-tax [2012] 343 ITR 270 (SC) etc.

⁶ Available at: <https://economictimes.indiatimes.com/news/economy/policy/govt-working-on-classification-of-cryptocurrency-under-gst-law/articleshow/90333798.cms> (last accessed on June 08, 2022).

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