Indian tax implications in cryptocurrency transactions

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Background

India's Finance Minister introduced a specific tax regime for virtual digital assets ("**VDAs**") in the Finance Bill 2022.

Section 2(47A) of the Income-tax Act, 1961 (the "**IT Act**") was brought in and defines VDAs to mean 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 which can be transferred, stored or traded electronically. VDAs include a non-fungible token or any other token of a similar nature, by whatever name called or any other digital asset as the Central Government may specify.

The Central Board of Indian Taxes has issued two (2) notifications no. 74 and 75 of 2022, which exclude the following items from the definition of VDAs:

a) gift cards or vouchers, being a record that may be used to obtain goods or services or a discount on goods or services;

b) mileage points, reward points, and loyalty cards, being a record: (i) given without direct monetary consideration under an award, reward, benefit, loyalty, incentive, rebate or promotional programme; and (ii) that may be used or redeemed only to obtain goods or services or a discount on goods or services;

c) subscriptions to websites, platforms, or applications; and

d) a non-fungible token whose transfer results in the transfer of ownership of the underlying tangible asset, which is legally enforceable.

Income tax provisions

Under the IT Act, Indian residents are subject to tax in India on their worldwide income, whereas non-residents are, *inter alia*, taxed on income that is deemed to accrue or arise in India. Non-residents who are residents of a country with which India has signed a double taxation avoidance agreement (a "**DTAA**") have the option of being taxed as per the provisions of the DTAA or the IT Act, whichever is more beneficial. Under the IT Act, the following sections are relevant to VDAs.

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- Section 2(47A) of the IT Act that has an expansive definition for VDA (already described above);

- Section 115BBH of the IT Act that provides for taxation of income from the transfer of VDAs at the rate of 30% (excluding surcharge and cess);

- Section 194S of the IT Act that provides for withholding tax on payment of consideration for the transfer of VDAs to residents; and

- Section 56(2)(vii) and 56(2)(x) of the IT Act that provide for tax on VDAs as income from other sources.

Goods and Services Tax ("GST") considerations

In India, GST is payable on:

- sale of goods where goods are sold within one state in India;
- sale of goods where goods are transported from one state to another state;
- the provision of services within one state in India; and
- the provision of services from one state to another state in India.

The applicability of GST on a virtual currency depends on whether the virtual currency can be considered as "goods." Currently, there is no guidance that expressly classifies virtual currencies as goods, although India's Supreme Court, in the *Internet and Mobile Association of India* case (Writ Petition (Civil) No.528 of 2018), considered whether virtual currencies can be categorised as money or goods (or commodities) and noted that virtual currencies have attributes of both these categories.

If virtual currencies are categorised as money, then no GST should be applicable as money is excluded from the scope of GST. However, in this case, the Supreme Court acknowledged that VDAs are capable of being considered intangible property and goods as well. So, if VDAs like cryptocurrency are considered as goods, then GST can be applicable at the rate of 18%. These concerns around VDAs are likely to be taken up in the upcoming GST Council meetings as there is no specific guidance on the application of GST to VDAs currently.

Brief overview on the Indian tax implications that can arise on VDA transactions

- ***On Indian resident individuals***: Any income arising from the transfer of VDAs will be taxable in the hands of the individual at the rate of 30% (plus applicable surcharge depending on the individual tax slab rates) and education cess at the rate of 4%. No deduction with respect to any expenditure or allowance (other than the cost of acquisition) will be available to the individual. Any loss arising from the transfer of VDAs will not be eligible for set off against any income or permitted to be carried forward for future tax assessment years.

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- ***On Indian resident corporate entities***: Any income arising from the transfer of VDAs will be taxable in the hands of Indian resident corporate entities at the rate of 30% (plus applicable surcharge) and education cess at the rate of 4%. No deduction with respect to any expenditure or allowance (other than the cost of acquisition) will be available for the corporates. Any loss arising from the transfer of VDAs will not be eligible for set off against any income or permitted to be carried forward for future tax assessment years.

- ***Fair Market Valuation***: Under the provisions of the IT Act, VDAs are considered as "property" and, thus, when the property is transferred by the seller, the seller must conduct a fair market valuation (the "**FMV**") of that property. Currently, no valuation method has been prescribed under the IT Act for determining the FMV of VDAs, but press reports indicate that an internationally accepted principle of valuation may work. Note that if the purchase consideration of the VDA does not adhere to the FMV, the differential amount (i.e., the aggregate fair market value of the VDA minus INR50,000 (approx. US$602) will be taxed as income from other sources at the rate of 30% (plus applicable surcharge and education cess at the rate of 4%) payable by the recipient of the VDA.

- ***Tax Withholding Obligations***: For the purpose of tax withholding, Section 194S of the IT Act was introduced with effect from July 1, 2022, under which an obligation is placed on a person to ensure that tax is withheld at the rate of 1% at the time of payment/credit of any sum to any resident as consideration for the transfer of a VDA. Where payment is wholly or partly in kind, the person responsible for paying such consideration shall ensure that tax has been paid prior to releasing such consideration. The threshold amount triggering tax withholding is an aggregate payment of INR 50,000 (approx. US$602) in case a specified person (i.e., an individual or Hindu Undivided Family) makes the payment; otherwise, it is INR 10,000 (approx. US$120) in a financial year. The tax deductor must furnish a quarterly statement in Form No. 26Q for all VDA transactions.

- ***VDAs received from mining*****:** As we understand it, mining is a process through which individuals having high processing computers solve complex mathematical problems and verify the transactions recorded on a blockchain for which they are rewarded in cryptocurrencies. Indian tax authorities may seek to tax such rewards based on FMV as income from other sources at the rate of 30% (plus applicable surcharge depending on the individual tax slab rates) and education cess at the rate of 4%.

- ***VDAs received by airdrop***: As we see it, airdrop is a marketing scheme where the issuers of a new cryptocurrency directly deposit the coins in an individual's wallet to increase the flow of the new coin. Indian tax authorities may consider the deposit of coins as a gift (instead of just receipts) and tax such gifts as income from other sources based on the FMV at the rate of 30% (plus applicable surcharge depending on the individual tax slab rates) and education cess at the rate of 4%.

- ***VDAs received from staking:*** As we see it, staking is a form of mining, where instead of solving complex mathematical problems to verify the transactions, individuals stake or

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bet their existing VDAs (including cryptocurrency) and verify the transactions on the blockchain, and if they do it correctly, they receive a reward in the form of VDAs which is proportionate to their stake. Indian tax authorities may seek to tax such rewards based on FMV as income from other sources at the rate of 30% (plus applicable surcharge depending on the individuals tax slab rates) and education cess at the rate of 4%.

- ***Tax treatment of a hard fork:*** A "hard fork" occurs when there is a change in a VDA (i.e., cryptocurrency) protocol that causes the blockchain to split into two: the "new" chain with the latest protocol and the old chain. Following a hard fork, holders of the forked cryptocurrency will receive an automatic distribution of the new cryptocurrency (commonly referred to as an "airdrop"). Individuals who choose the new version of cryptocurrency are rewarded with new coins based on whatever amount they were holding before. The Indian tax authorities may (if a tax scrutiny is conducted) seek to tax such rewards based on FMV as income from other sources at the rate of 30% (plus applicable surcharge depending on the individuals tax slab rates) and education cess at the rate of 4%.

- ***Employee remuneration in VDAs*****:** If an employee receives remuneration in VDAs in a given financial year, then the employer will have the statutory obligation to withhold income tax at the rate of 30% (plus applicable surcharge depending on the individual's tax slab rates) and education cess at the rate of 4%. The employee will not be eligible to claim any deductions on any expenditure or allowance (other than the cost of acquisition). The employer will have to issue a tax deduction certificate to the employee at the end of the financial year to enable the employee to claim credit for tax withheld at source at the time of filing his/her income tax returns.

- ***Selling VDAs for Indian Rupees (INR) or any other fiat currency***: If an individual (or a corporate entity) sells VDAs in exchange for traditional currency, then any profits derived from the transaction will be subject to a tax rate of 30% (plus applicable surcharge and education cess).

- ***Trading VDAs for other VDAs***: If an individual (or a corporate entity) participates in the exchange of one type of VDA for another, or enters into a swap arrangement for VDAs, the resulting profits will be taxed at a rate of 30% (plus applicable surcharge and education cess).

- ***Spending VDAs on goods and services***: Using VDAs to purchase goods or services will be subject to tax at the rate of 30% (plus applicable surcharge and education cess).

- ***Tax Reporting obligations***: Under the IT Act, if an Indian resident is holding VDAs, then there is no specific obligation to make a disclosure to the Indian tax authorities. However, if there is a transfer of VDAs resulting in capital gain or loss, it will have to be reported at the time of filing the tax return by the Indian resident. Note that a separate Schedule has been introduced in the tax return forms to report income from VDA.

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Further, in Schedule CG in relation to capital gains under Table F, a quarterly breakup of the VDA income is also required to be reported.

Our comments

As we see it, the cryptocurrency industry is still in a nascent stage with skewed knowledge available regarding its working, which complicates its classification and, therefore, its categorization under India's taxation system. The tax rate of 30% (irrespective of the income bracket of the taxpayer), non-availability of any deductions (other than the cost of acquisition), non-availability of set-off of losses, and the requirement to withhold tax, all seem to be aimed to discourage investments in VDAs.

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