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NITTY-GRITTIES' OF DIRECT TAXATION ON TRANSFER OF VIRTUAL DIGITAL ASSET

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1. Objective of the article :

The purpose of this article is to examine the applicability of relevant provisions of the Income-tax Act of 1961 ("the Act") to Virtual Digital Assets ("VDA"), also known as Digital Currencies and Non-Fungible Tokens ("NFT(s)"). It maps the tax treatment of each key taxable event under the relevant scenarios, while specifically focusing on the requisites applicable to non-residents.

2. Relevant provisions of the Income-tax Act, 1961 and their analysis

2.1 The exponentially growing digital and crypto economies and their popularity have led the Government of India to introduce the Scheme for taxation of Virtual Digital Assets (VDA). It is pertinent to note that the Government had previously proposed schemes to regulate the taxation of VDAs under the Finance Bill, 2022[3] ([2022] 440 ITR (St.) 59). These proposals have now been added to the Finance Act, 2022[4] ([2022] 442 ITR (St.) 91) with the assent of the hon'ble President of India on March 30, 2022.

2.2 At the outset, it is relevant to understand the term "VDA" as defined under clause (47A) of section 2. According to this clause, VDA means "any information or code or number or token (not being Indian currency or any foreign currency), generated through cryptographic means or

1. IRS (Former Chief Commissioner of Income-tax), Director – Tax Advisory, Fox Mandal & Associates.
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3. *https ://www.indiabudget.gov.in/doc/memo.pdf*
4. *http ://164.100.47.4/BillsTexts/LSBillTexts/PassedBothHouses/18F_2022_LS_E.pdf*

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 schemes, and can be transferred, stored or traded electronically". Non-fungible tokens ("NFT") and any other token of similar nature are also included in the definition. Thus, VDA would cover virtual currencies like Bitcoin, Ethereum, Altcoin, etc. and NFT's.

2.3 A new section 115BBH is inserted in the Income-tax Act, 1961 in relation to income from transfer of VDA which provides for the computation mechanism and rate of tax. The said section reads as under :

"(1) Where the total income of an assessee includes any income from the transfer of any VDA, notwithstanding anything contained in any other provision of this Act, the income-tax payable shall be the aggregate of,—

(a) the amount of income-tax calculated on the income from transfer of such VDA at the rate of 30 per cent. ; and

(b) the amount of income-tax with which the assessee would have been chargeable, had the total income of the assessee been reduced by the income referred to in clause (a).

(2) Notwithstanding anything contained in any other provision of this Act,—

(a) no deduction in respect of any expenditure (other than cost of acquisition, if any) or allowance or set off of any loss shall be allowed to the assessee under any provision of this Act in computing the income referred to in clause (a) of sub-section (1) ; and

(b) no set off of loss from transfer of the virtual digital asset computed under clause (a) of sub-section (1) shall be allowed against income computed under any provision of this Act to the assessee and such loss shall not be allowed to be carried forward to succeeding assessment years.

(3) For the purposes of this section, the word 'transfer' as defined in clause (47) of section 2, shall apply to any virtual digital asset, whether capital asset or not."

2.4 According to the above provisions, any income of an assessee (whether resident or non-resident) arising from the transfer of a VDA will be taxed at the rate of 30 per cent. on the sale consideration as reduced by the cost of acquisition, if any. No deductions of expenses and set-off of losses are allowed in computing the income from the transfer of VDA

under any provisions of the Act. Furthermore, the loss from the VDA transfer shall not be carried forward for any subsequent assessment year(s).

2.5 Also, it may be inferred from section 115BBH that the income from VDA shall be computed and taxed in terms of the said section irrespective of the fact that the VDA is characterised as a capital asset or stock-in-trade/trading asset. The income from the transfer of VDA can be offered to tax under the head of Business or Profession or Other sources or Capital Gains depending on the nature of holding the VDA.

2.6 Further, as section 115BBH has an overriding effect over the other provisions of the Act, the eligible assessee will not be allowed to enjoy the benefit of the rebate under section 87A.

2.7 *Taxation of gifts received by residents* : Taxation of gifts are governed by section 56(2)(x). An amendment is made to the *Explanation* to section 56(2)(x) by which VDAs are also included in the definition of "property". Thus, receipt of VDA as a gift from one person to another for nil or inadequate consideration shall be considered as income from other sources and shall be taxable at the rate of 30 per cent. in terms of section 115BBH. However, the existing provision for exemption as provided in the proviso to section 56(2)(x) will continue to apply. The exemptions include any property received from a relative or on the occasion of the marriage of the individual or under a will or by way of inheritance, etc., subject to the provisions in the Act.

2.8 According to the *Explanation* to section 56(2)(x), fair market value of the property means the value determined using the method(s) prescribed by the Competent Authority. However, the methods of valuation of VDA are yet to be prescribed.

3. Compliance with TDS provisions

3.1 In order to ensure the collection of tax at source from the transfer of VDA, the payer (any person who is paying consideration to another person on the transfer of VDA) is obligated to deduct tax at source in the name of the seller/transferor and remit the same to the Government under section 194S, which is effective from July 1, 2022. The rate prescribed for the deduction of tax on such a payment to a resident for the transfer of VDA is at the rate of 1 per cent. of consideration. However, in the event that the payment for such a transfer is—

(i) entirely in kind or in exchange for another VDA ; or

(ii) partly in cash and partly in kind but the part in cash is not sufficient to meet the liability of deduction of tax in respect of the whole of such transfer,

the person making the payment shall ensure that tax required to be deducted has been paid in respect of such consideration for the transfer of VDA.

3.2 No tax is to be deducted in case the payer is the specified person and the value or the aggregate of such value of consideration to a resident is less than INR 50,000 during the financial year. The phrase "specified person" refers to :

(i) individual or Hindu undivided family whose total sales, gross receipts or turnover from the business carried on by him or profession exercised by him does not exceed one crore rupees in case of business or fifty lakh rupees in case of profession, during the financial year immediately preceding the financial year in which such virtual digital asset is transferred.

(ii) individual or Hindu undivided family having an income under any head other than the head "Profits and gains of business or profession".

In the case of any other person other than the specified person, the said limit is reduced to INR 10,000 during the financial year.

3.3 It can be said that the payee must be a resident of India to comply with section 194S. However, the payer (buyer of VDA) must deduct tax at source, whether he is a resident or a non-resident.

3.4 In the event that the payee who receives consideration on the transfer of VDA is a non-resident, then section 195 will apply (Discussed later in para 5.5).

3.5 The scheme also provides for some relief for the deduction of taxes at source under section 194-O under certain circumstances. Section 194-O makes e-commerce operators responsible for deducting tax at source for the supply of goods or services, including digital products over digital networks. According to sub-section (4) of section 194S, in the case of a transaction where tax is deductible under section 194-O along with section 194S, the tax shall be deducted under section 194S and not under section 194-O. Section 194S has an overriding effect over section 194-O. However, section 194S does not have an overriding effect on the entire Chapter XVII dealing with the collection and recovery of tax. Though the overriding effect was provided in the Finance Bill, 2022, the same was omitted in the Finance Act, 2022.

3.6 Further, an application for lower or nil deduction of tax under section 197 can be made before the tax authorities in the case of total income is loss or does not exceed the basic exemption limit by the payee (person who receives consideration on transfer) before the deduction of tax.

3.7 Considering the present scenario, the trading of virtual assets/currencies is undertaken through virtual currency exchanges wherein the buyer and seller of a particular sale transaction are anonymous to each other, akin to the regular stock exchange scenario. In such cases, it is challenging to comply with section 194S for the payers who are dealing in VDAs. The buyer will not know the seller from whom the VDA is bought or vice versa unless the transaction is entered through a peer-to-peer exchange, a third-party intermediary or any off-market transaction.

4. Key taxable events

4.1 For ease of understanding, each key event in the lifecycle of the present crypto transaction is discussed to analyse the applicability of VDA taxation.

4.2 Let's assume that Mr. A is a trader who mines and trades in various VDAs. M/s. X is a Virtual Currency Exchange Company (Peer-to-Peer Platform) which provides a platform to the traders for buying and selling the VDAs and M/s. Y is carrying out a crypto project whose crypto coin (assume BunnyCoin) is listed in the market. The BunnyCoins are created through the method of cryptography under distributed ledger technology. The assessees in the examples are residents unless specifically expressed as non-residents.

Illustrative scenarios

Scenario 1 : Mr. A mines the BunnyCoins and buys a few BunnyCoins from the market. Mr. A receives these BunnyCoins in his wallet. Subsequently, Mr. A transfers these BunnyCoins to another wallet to trade the coins. Mr. A transfers all the BunnyCoins that were bought and mined to another person, say Mr. B, on the platform made available by M/s. X. M/s. X charges a transaction fee for facilitating this transaction. Mr. B pays adequate cash consideration for the transfer of such a VDA. What will be the tax implications in relation to VDA for Mr. A, Mr. B and M/s X ?

Answer 1 : The BunnyCoin is a VDA as it satisfies the definition provided under section 2(47A).

(a) Mr. A – According to the current tax scheme, BunnyCoins obtained as consideration for carrying-out mining activity will not attract VDA taxation. However, for the sake of clarity, the Government needs to bring better understanding of VDA taxation for the miners' community.

* Moving BunnyCoins from one wallet to another wallet will not attract tax in the hands of Mr. A.

* Transfer of BunnyCoins to Mr. B will be regarded as a transfer of VDA, and subject to taxation in terms of section 115BBH, which would be as follows :

Particulars	*Amount (INR)*
Sale consideration	xxxx
Less : Cost of acquisition (bought BunnyCoins)	(xxx)
Cost of acquisition (mined BunnyCoins)	Nil
Transaction fee	Nil
Capital gain	xxx
Tax thereon at 30%	xx
Add : Surcharge and cess, if any	x
Tax liability	xxx

(b) Mr. B – According to section 194S, Mr. B will be responsible for deducting TDS at 1 per cent. of consideration and remitting the amount to the Government unless he is covered by the exceptions provided in the Act as mentioned in para 3.2.

(c) M/s. X – There is no transfer of VDA by M/s. X under section 115BBH. The Virtual Currency Exchange has provided a platform for Mr. A and Mr. B to execute the buy and sell transactions, for which it has charged a transaction fee. The transaction fee, however, will be charged under other provisions of the Act and not under section 115BBH.

Scenario 2 : Similar facts as stated in scenario 1, but instead of cash consideration, there is an exchange against another Virtual Digital Asset. What will be the tax implications for Mr. A and Mr. B in relation to the transfer of VDA ?

Answer 2 : The income from the transfer of VDA is taxable in the hands of both Mr. A and Mr. B. Then, both the parties will be responsible for deducting tax at source under section 194S (similar to answer 1 of part a and b). Both Mr. A and Mr. B will be considered as payer and payee for each leg of the transaction. Now the question arises as to how to determine the consideration in the hands of both individuals for the purpose of deduction of tax. This depends on the methods of valuation that are going to be prescribed by the Government.

Scenario 3 : Mr. A pays his BunnyCoins as consideration for the supply of other goods and services from Mr. B. What will be the tax implications for Mr. A and Mr. B in relation to the transfer of VDA ?

Answer 3 :

(a) Mr. A – The income from the transfer of VDA would be taxed as suggested in answer 1, Part a.

Let's say, the transfer of VDA is in exchange of professional services then Mr. A shall ensure tax is deducted at source under section 194J as applicable.

(b) Mr. B – Supply of goods and services will be taxed in terms of the other applicable provisions of the Act. Mr. B is required to deduct tax under section 194S because he is supplying goods or services in exchange for VDA.

Scenario 4 : M/s. Y carries out the following list of activities for their new project :

(a) Airdrops (meaning distribution of tokens without consideration) of coins in the market.

(b) Initial token offering (ITO) (meaning the issue of new tokens in exchange of adequate cash consideration to raise capital).

What will be the tax implications for the receivers of coins ?

Answer 4 :

(a) *Airdrop* : According to the amended section 56(2)(x), the airdrop of cryptocurrency will attract tax in the hands of the receiver as such an airdrop is considered a transfer without any consideration. The tax will be computed in terms of section 115BBH (as increased by the applicable surcharge and cess). Section 194S will not apply, as there is no consideration involved for the transfer of VDA.

(b) *Initial Token Offering (ITO)* : The receivers of the tokens in relation to coins are required to deduct tax at source as suggested in answer 1, part b.

Scenario 5 : Mr. A creates an NFT of a digital image of an animal. He sells the NFT and claims a royalty on each subsequent sale in the secondary market. Mr. A is charged a minting fee or gas fee for the purpose of listing the NFT. What will be the tax implications in the hands of Mr. A in relation to the transfer of VDA ?

Answer 5 : On the sale of NFT, Mr. A's income will be computed and taxed as mentioned in answer 1, Part a and the corresponding buyer shall be required to deduct tax as suggested in answer 1, part b.

However, in relation to royalty income received on subsequent sales in the secondary market (where the transfer takes place between subsequent buyers and subsequent sellers), the income will be subject to tax under the other provisions of the Act.

5. Taxation for non-residents on transfer of VDA

5.1 Let's consider a situation wherein there is a non-resident who transfers VDA to a resident for cash consideration that is transferred to his bank account outside India.

5.2 According to section 5(2), a non-resident is chargeable to tax with respect to the income received or deemed to be received or which accrues or arises or is deemed to accrue or arise to him in India.

5.3 Section 9 relates to income deemed to accrue or arise in India. All income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India.

5.4 Where the income accrues/arises/received by a non-resident in India, it shall be taxable in terms of the new provisions of the Act.

5.5 Similarly, section 195 will be applicable to the payer (whether resident or non-resident) on any payment of consideration on transfer of VDA to a non-resident or foreign company. The applicable tax for deduction would be 30 per cent. plus applicable surcharge and cess as mentioned in section 115BBH.

5.6 *Taxation of gift received by non-resident* : Where a non-resident receives VDA for inadequate or no consideration, the same shall be considered income deemed to accrue or arise in India under section 9(1)(viii). Thus, gift of VDA to a non-resident will be considered as income in the hands of the non-resident. However, the existing provision for exemption as provided in the proviso to section 56(2)(x) will continue to apply.

6. Practical challenges

There are still a few practical challenges to complying with the discussed provisions envisaged under the Finance Act, 2020, such as :

6.1 What is the valuation mechanism to be adopted for computing the fair value of consideration on the transfer of VDA ?

6.2 Whether cost of acquisition of VDA would include cost incurred for mining of VDA, brokerage fee paid and transaction fee paid ?

6.3 Whether a non-resident will be eligible to claim the benefit of lower rate of tax or the separate tax computation mechanism provided by the Double Taxation Avoidance Agreement (DTAA), if any, against the non obstante clause provided under section 115BBH ?

6.4 What will be the tax implications of the transfer of VDA for the financial year 2021-22 and earlier years ?

As the Government is positive and proactive in this regard, the changes can be expected, and the clarity may come soon.

7. Conclusion

The taxation of VDAs is a new chapter in the Indian Income-tax Act and the Government of India has taken a lead in this regard, which is a welcome step. However, crypto-investors and all stakeholders are still seeking clarification on the guidelines to conduct business and navigate the payment of taxes on crypto gains going forward. In April, the Government announced that it is working on preparing an FAQ (frequently asked questions) document to afford nuanced clarity regarding the taxation of VDAs for the purposes of GST and Income-tax. The Department of Economic Affairs, the Department of Revenue and the Reserve Bank of India are jointly working on FAQs for tax offices in the field as well as crypto-dealers and investors of other virtual digital assets.[1] It will be interesting to see how the Indian legislation evolves to embrace and integrate VDAs into the current investment and financial ecosystem.

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1. *https://www.business-standard.com/article/markets/faq-on-taxation-of-cryptocurrencies-virtual-digital-assets-in-works 122041000194_1.html.*