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THE TIMES OF INDIA

Explained: Crypto exchanges may move base overseas but you will still have to pay tax on your cryptocurrency

TIMESOFINDIA.COM | Feb 22, 2022, 01.14 PM IST

NEW DELHI: With the United Arab Emirates and Singapore keen on becoming the next crypto hubs amid regulatory uncertainty over cryptocurrencies across the world and especially in India, several Indian crypto exchanges are moving their bases out of the country. The fear is that India's 30 percent tax proposal on all digital assets will drive investors to Chinese crypto websites that don't even have the basic Know Your Customer requirements.

How Dubai and Singapore are wooing investors:

In December 2021, the world's biggest cryptocurrency exchange by volume, Binance inked a pact with Dubai World Trade Centre Authority (DWTCA), which is working to establish an international virtual asset ecosystem. DWTCA is a favorable regulated zone for crypto service providers in Dubai. The government also wants to create a favorable environment for crypto mining and Bloomberg reported that UAE is planning to issue a federal crypto license for virtual asset service providers by the end of the first quarter of 2022.

The UAE is the third-largest crypto market in the Middle East behind Turkey and Lebanon and one of the world’s fastest-growing markets, according to an October 2021 Chainalysis report.

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Meanwhile, Bloomberg reported that Monetary Authority of Singapore, which regulates banks and financial firms, is putting in place “strong regulation,” so firms that meet its requirements and address the multitude of risks can operate. Singapore has already attracted the likes of Binance Holdings. which has had a series of run-ins with regulators around the world, to Gemini, a US operator targeting institutional investors, to set up base.
Singapore and Dubai are not the only two with crypto ambitions. Locations like Estonia, Miami, El Salvador, Malta and Zug in Switzerland, are also doing their bit to lure the crypto and blockchain industry.

The government proposal that has crypto exchanges worried in India

During the budget announcement, Finance Minister Nirmala Sitharaman not only placed earnings from cryptocurrencies and non-fungible tokens (NFTs) in India's highest tax band of 30 percent, she also said losses from their sale could not be offset against other income, delivering another disincentive to trading and investment in digital assets. The government also introduced a 1% TDS on digital assets. For instance, if you made a profit of Rs 100, then including the 30% tax bracket, plus surcharge and cess the total tax outgo will be around Rs 42!

Post the Budget announcement, the introduction of the crypto tax was widely seen as a form of legal recognition of cryptocurrencies in India but the notion was debunked by the head of the country’s Central Board of Direct Taxes. "“The crypto trade or the digital assets transactions do not ipso facto become legal or regular just because you have paid taxes on that," said CBDT chief J.B. Mohapatra. He added that the new crypto tax would help the income tax department measure the depth of the digital currency market in the country and stressed that imposing a tax on the nascent crypto market doesn’t necessarily legalize its trade in the country.

The government has been working on crypto regulatory frameworks since 2019 but is yet to introduce a crypto bill.

Hedge against uncertainty

When the RBI banned cryptocurrencies in India in 2018, several exchanges that were to start shop in India decided to set up base overseas despite the cost being higher in order to hedge against an uncertain regulatory environment.

Take the example of Vauld, which is a Singapore-based crypto exchange that has raised nearly $28 million since 2020. "We decided to set up shop in Singapore, and didn't accept a single Indian customer until the Supreme Court had lifted the ban. And despite that, we will comply with all regulatory requirements in India, which includes the 1 percent TDS and Equalisation levy," says Darshan Bathija, CEO and co-founder of Vauld. The idea of having a base outside is not to try and avoid the tax repercussions in a particular country, but rather to have a hedge against any possible uncertainties, he says. " As a purely Indian company, it is difficult to get financing from US banks. We wanted to service a global landscape to start with. At the time, we didn't know if India would be an opportunity or not," he added.

Global exchanges are holding back India investment

Despite regulatory uncertainty, India already has two crypto unicorns in CoinDCX and CoinSwitchKuber. But the recent complicated tax policies could prove to be a damper for fund raising by the industry as TDS compliance and a high tax rate will make it difficult for multinational entities and exchanges to set up shop in the country.

Cryptocurrency companies raised a record $34 billion in 2021, higher than the amount from all prior years combined, with over half of it coming from the US. Now, several global crypto exchanges are awaiting more clarity on regulations before investing in the country.

KuCoin, one of the world’s largest exchanges, will only increase investment in India once the crypto bill is passed while US-based Coinbase is waiting for the final contours of the Bill before starting India operations.

“I got a call from one of the top three crypto exchanges in the world, who are considering entering India, but after yesterday’s announcement, they seem to be holding back the idea. Just because of the complexity involved around the taxation of crypto.

Clearly, a complicated tax framework will discourage international companies from investing and starting operations in our country,"Siddharth Sogani, founder and CEO of blockchain data analytics firm Crebaco is quoted as saying by Cointelegraph.

Unfriendly tax policies will drive out companies and talent out of India

Experts in the industry believe that unfriendly taxation policies will ultimately drive companies out of the country towards nations that are more tax-friendly. Thailand recently quashed its 15% tax proposal on crypto transactions after backlash from retail market operators while South Korea has delayed its 20% tax proposal due to a lack of clarity on crypto regulations.

"Many exchanges set up their headquarters in countries such as the USA, Dubai, or Singapore because of the regulatory certainty in those countries, as many countries including India had a regulatory gray area when it came to cryptocurrencies. However, if the exchanges are moving out, then they will need to register themselves in the said country they are planning to move into, which is a complex process. They also need to operate within that particular country's rules and regulations," said Edul Patel, CEO and co-founder Mudrex, a global algorithm based crypto investment platform, which has offices in both India and the US.

In the US, the IRS views cryptocurrency as a capital asset, which means there are taxes to be paid on any gains obtained from selling them. So you will pay short-term capital gains tax if you have held the security for one year or less, and you'll pay long-term capital gains tax if you held your position for longer than one year. Holding the crypto asset means no taxation is involved. If you incur a loss, you don't owe any taxes on that transaction, although you must still report these crypto losses when filing your tax return.

Polygon, an Ethereum scaling platform, has shifted most of its operations from Bengaluru to Dubai and the US due to the policy uncertainty surrounding the Indian crypto community. "It is not just the recent tax announcements that have made the crypto exchanges go outside India. They have been doing it for a few years now because the regulations are not there in India and many crypto exchanges are playing it safe in case there is a regulation tomorrow to ban the crypto business, said Rashmi Deshpande, Partner, Khaitan & Co.

Why do they prefer destinations like Dubai and Singapore even if it is more expensive to set up base there?

The regulatory and tax regime in countries like Singapore or Dubai are clearer and friendlier. Moving their base overseas may help crypto exchanges escape Indian tax laws to some extent, as they would no longer have a permanent establishment in India.

"In India, future legality of crypto remains a question and the proposed tax regime is prohibitively high. However, if they are servicing Indian customers from outside india, applicability of equalisation levy, GST on import of online services by users, tax deduction at source and the tax base could still be grey areas. Still, on balance it would be more advantageous to be outside of India rather than operate from within India," says Meyyappan Nagappan, leader, Digital Tax, Nishith Desai Associates.

But is it possible to move base overseas?
India-based Crypto exchanges would have to examine Indian Exchange Control Regulations on outbound investments to ensure that the exchange is set-up in a compliant manner. Setting-up outside India may help exchanges to attract overseas investors. Also, from a compliance standpoint it may be practically possible to move away from the withholding tax compliances which are imposed on the exchange as per the recent budget amendments, said Nishit Parikh, Partner, Direct and International Tax-Sudit K Parekh & Co LLP.

What are the repercussions of moving base outside of India?
Even if an exchange moves base out of India, it will still be liable to pay tax here. "The way the new income tax law on taxation of cryptocurrency is worded, it seems that tax will also be applicable on cryptocurrency income related to selling cryptos on a crypto exchange not based in India, i.e. it is irrespective of which crypto exchange the trading is done," said Archit Gupta, CEO & Founder of Clear.

The crypto traders will need to pay tax at 30% on the transfer of cryptocurrency from the exchange located overseas and the funds repatriated to India. Moreover, 1% TDS will also be required to be deducted on the transfers subject to the threshold limit. However, clarity is required from the government for compliances where it will be difficult for the buyer to deduct and report TDS without the seller’s information. The seller’s information is confidential and not shared by the crypto exchanges, added

Gupta.

"If the crypto exchanges move out their operations from India relating to sale and purchase of cryptocurrencies, then taxability of income arising from exchange operations will be decided based on the provisions under the Indian Income-tax law read with the provisions of double taxation avoidance agreement ('DTAAs') of the respective country where the operations of these crypto exchanges will be based out.

The Income-tax department may argue that these foreign based crypto exchanges facilitate transactions in cryptocurrencies for people resident in India and therefore, such crypto exchanges have a business connection in India.

In this regard, the Indian Income-tax Department may also rely on the "Significant Economic Presence" provisions embedded in Section 9(1)(i) of the Indian Income-tax Act to say that the activities carried out by foreign based crypto exchanges with Indian investors amounts to systematic and continuous soliciting of business activities in India.

"Accordingly, any income arising out of exchange operations to the extent of transactions with persons resident in India, shall be taxable in India. As regards the taxability under the DTAAs, the crypto exchanges shall be liable to tax only in India subject to fulfilment of "permanent establishment" provisions," explains L .Badri Narayanan, Executive Partner, Lakshmikumaran & Sridharan Attorneys.

And what does this mean for investors in India?
The investors who are resident in India will be governed by the newly proposed provisions under the Finance Bill, 2022. The foreign investors may not be taxed in India based on the nexus and territorial principles.

"The exchange operations carried outside India involving non-resident investors, will not be subject to tax in India in the absence of having any nexus with India. However, the transactions in crypto currencies involving resident persons in India, may pose several challenges relating to liability to recover tax, apportionment of income derived by exchanges with persons resident in India and their taxability. Further, the Equalisation levy provisions may also apply as the sale and purchase of digital assets may amount to facilitation of e-commerce supply or services," added Narayanan.

The crypto holder in India will not be absolved of tax liability in India just because the exchange is headquartered overseas

The investors will need to report the cryptocurrencies held in exchanges located overseas as foreign assets in their income tax returns, said Gupta. Further, the finance bill 2022 has not clarified that the transaction in virtual digital assets by the resident Indians (buyers) on foreign crypto exchanges could be subject to an equalization levy.

“Moving the Crypto exchanges overseas will make it difficult for the tax department to trace transactions but it will not absolve the holder of the crypto asset from a tax liability in India. It may also be counterproductive and may lead to the tax department becoming aggressive towards such transactions, potentially making crypto exchanges responsible for compliances under Indian tax law similar to e-commerce platforms. Crypto exchanges moving overseas will also need to carefully evaluate their regulatory (exchange control) positions and tax liability in India on account of continuing digital presence in India," said Sridhar R, Partner Tax and Grant Thornton Bharat, a global audit tax and advisory firm.

Crypto exchanges shifting outside India will also make investments difficult for Indian investors as any cross-border transaction in India is governed by Foreign Exchange Management Act, 1999 (FEMA).

" For investment in crypto outside India, individuals would have to go under the Liberalised Remittance Scheme (LRS) under FEMA which allows investors to invest only upto $2,50,000 per financial year. This is a total limit for all transactions put together. So, if an individual already has exhausted this limit on foreign travel, children education, etc. he may not be able to make an investment. Also, tax collection at source (TCS) provisions are applicable on foreign remittance transactions whereby banker would be required to collect tax at source on remittance above Rs 7,00,000. From corporate entity perspective as well, they would be required to examine the FEMA regulations before making such investments and would have to comply with the regulations depending on how they treat the crypto in their books," said Parikh.