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1. Forthcoming India chapter in the Virtual Currency Regulation Review

July 15, 2022

I. Preface

This is an updated version of the India chapter authored by Nishith Desai Associates as it appears in The Virtual Currency Regulation Review, edition 4. It is yet to be finalised and the fully-updated final version will appear in the 5th edition, to be published in September 2022.

The Virtual Currency Regulation Review is a country-by-country guide to recent legal and regulatory changes and developments in the field of virtual currencies, which also looks forward to expected global trends in the area. It provides a practical analysis of developing regulatory initiatives aimed at fostering innovation, while at the same time protecting the public and mitigating systemic risk concerning trading and transacting in virtual currencies.

Vaibhav Parikh and Jaideep Reddy[1]

1. Vaibhav Parikh and Jaideep Reddy are lawyers at Nishith Desai Associates. Meyyappan Nagappan and Ipsita Agarwalla, lawyers at Nishith Desai Associates, contributed to the tax portions of this chapter.

II. Introduction to The Legal and Regulatory Framework

As the law currently stands, there is no sector-specific regulatory framework for virtual currencies, cryptoassets, virtual digital assets or cryptocurrencies in India. On 4 March 2020, the Supreme Court of India set aside, on constitutional grounds, a circular (the VC Circular) issued by India's central bank, the Reserve Bank of India (RBI), which restricted the use of regulated banking and payment channels for the sale and purchase of virtual currencies (the *IAMAI* case).[2] This affirmed virtual currency exchanges' fundamental right to trade and do business, guaranteed under the Constitution of India. Effective April 2022, a new income tax regime was introduced for virtual digital assets, and effective June, 2022, new cybersecurity provisions were introduced for virtual asset entities.

In the past, the RBI and the Ministry of Finance have issued warning statements about the risks associated with virtual currencies, including money laundering, consumer protection, market integrity, cybersecurity and volatility. However, various government committee reports have also lauded certain advantages of virtual currencies, such as efficiency and cost-savings.

In 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 virtual currencies (the IMC Report). The Committee recommended an outright prohibition, along with criminal penalties, on dealing with virtual currencies.[3] It also recommended the promotion of distributed ledger technology without the use of virtual currencies, and the exploration of a sovereign digital currency. The Committee's recommendation is non-binding and appears to be under consideration by the government. A statement by a senior Ministry of Finance official in June 2022 indicates that the government will introduce a consultation paper on regulating the industry, having "sought viewpoints of both domestic institutional stakeholders and international organizations including the World Bank and the International Monetary Fund (IMF)".[4]

At the time of writing, there are over 20,000 virtual currencies in existence,[5] all with differing properties, and their categorisation depends on their nature.[6] For instance, some are intended to be electronic cash (e.g., Bitcoin) and some are intended to be 'gas' for computer processing operations (e.g., Ether).

Most of the laws referred to in this chapter are all of general application with no specific provisions on virtual currency, and we have interpreted them in the context of virtual currency.

2. Internet and Mobile Association of India v. Reserve Bank of India, W.P.(C) 528/2018, Supreme Court of India, 4 March 2020. The authors advised the Internet and Mobile Association of India (the lead petitioner in the case and the industry body) in the proceedings against the RBI.
3. https://dea.gov.in/sites/default/files/Approved%20and%20Signed%20Report%20and%20Bill%20of%20IMC%20on%20VCs%2028%20Feb%202019.pdf (23 June 2020).
4. http://timesofindia.indiatimes.com/articleshow/91956876.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst (16 July 2022).
5. https://coinmarketcap.com/all/views/all/ (16 July 2022).
6. A useful definition provided by the Financial Action Task Force is as follows: 'Virtual Currency means a digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued nor guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency.'

III. Securities and Investment Laws

A. Virtual currencies as securities

As the law currently stands, virtual currencies in the nature of Bitcoin and Ether are unlikely to attract regulations relating to securities. The Securities Contracts (Regulation) Act 1956 (SCRA) provides a non-exhaustive definition of securities, and there is currently no regulatory guidance on its application in the virtual currency context. Virtual currencies do not fall within the enumerated items of the definition. Further, the items under the definition derive their value from an underlying asset. However, virtual currencies like Bitcoin and Ether do not have underlying assets. Rather, the value is determined purely based on demand and supply. Further, virtual currencies such as Bitcoin often do not have an identifiable issuer, unlike the items in the definition of security under Indian law.

Even when considering the ordinary meaning of the word 'security', the word is defined in Black's Law Dictionary[7] to include an instrument evidencing a holder's ownership rights in a firm or a holder's creditor relationship with a firm (or government). It also states that a security indicates an interest based on investment in a common enterprise. Virtual currencies, including Bitcoin and Ether, do not have such ownership rights, credit relationships or investment in a common enterprise. Therefore, such virtual currencies are unlikely to fall within the definition of securities.

However, some tokens (although not all) issued through initial coin offerings (ICOs) may fall within the ambit of the SCRA if they are issued by an Indian entity and meet the above tests. This is likely to be the case if they are issued by an identifiable issuer and are backed by the underlying assets of the issuer. Such tokens should be subject to regulation under the Companies Act 2013 (the Companies Act) (in respect of requirements surrounding the issuance and transfer of securities) and the SCRA (in respect of securities only being allowed to be listed on licensed stock exchanges).

Some issuances of virtual currency tokens may also amount to collective investment schemes, which are regulated under the Securities and Exchange Board of India Act 1992.[8]

B. Deposits

Since many token sales involve the acceptance of money or other tokens, it is relevant to analyse what regulations other than securities regulations (e.g., for tokens that do not qualify as securities) apply in such sales.

The regulations under the Companies Act and the Companies (Acceptance of Deposits) Rules 2014 (Deposits Rules) specify when the receipt of money, by way of deposit or loan or in any other form, by a company would be termed a deposit, and also provides certain exemptions from its applicability. For example, any amount received in the course of business as an advance for the supply of goods or services would not be a deposit if the advance is appropriated against the supply of such goods or services within 365 days. If a company is deemed to be accepting deposits, a variety of compliance steps under the Companies Act and its rules, along with RBI regulations, would be triggered. Only the receipt of money, and not virtual currency, would trigger these steps.

7. Black's Law Dictionary (10th edition 2014).

8. This will be the case if: (1) the contributions, or payments made by the investors, by whatever name called, are pooled and utilised for the purposes of the scheme or arrangement; (2) the contributions or payments are made to such scheme or arrangement by the investors with a view to receive profits, income, produce or property, whether movable or immovable, from such scheme or arrangement; (3) the property, contribution or investment forming part of scheme or arrangement, whether identifiable or not, is managed on behalf of the investors; and (4) the investors do not have day-to-day control over the management and operation of the scheme or arrangement.

Further, after the issuance of the Banning of Unregulated Deposit Schemes Act 2019, virtual currency token issuers will need to ensure, to be outside the purview of the Act, that any money received should not be liable to be returned.[9]

C. Regulation as commodities

In the *IAMAI* case, the Supreme Court expressed some doubt over whether a virtual currency could be classified only as a good or commodity. Ultimately, it held that a virtual currency is an intangible property that acts under certain circumstances as money.

India is a country with capital controls, where the inflow of foreign exchange into and outside the country is regulated under the Foreign Exchange Management Act 1999 (FEMA). If virtual currencies are classified as commodities, the activity of operating an exchange for trading virtual currencies may be regulated as a commodities exchange, which can have implications under India's regulation on inward foreign direct investment (**FDI**), that is, the Foreign Exchange Management (Non-debt Instruments) Rules 2019 **(**the NDI Rules).

Within the commodity space, there are two relevant concepts: a commodities spot exchange, which deals with ready delivery, and a commodities derivative exchange, which deals with derivative contracts. The NDI Rules restrict the amount of foreign investment into commodity spot exchanges to up to 49 per cent of the share capital, without government approval. The SCRA requires that any exchange facilitating commodity derivatives needs to be a recognised stock exchange (i.e., a licensed entity).

As the law stands, virtual currencies may not be regulated as commodities within the meaning of the NDI Rules. According to a Securities and Exchange Board of India (SEBI) Circular[10] read with a central government notification[11] under the SCRA, the central government has notified certain goods for the purpose of the term commodity derivative under the SCRA and does not include any virtual currency. While this notification is only applicable to commodity derivatives and not ready delivery contracts, it provides the closest guidance on the point of what may be considered a commodity exchange at the moment.

However, the central government may at any time choose to notify virtual currencies (in general, or any class of them) as commodities under the above notification. This would bring derivatives contracts in virtual currencies within the SCRA (and hence, SEBI's jurisdiction). For spot trading, FDI would then be restricted to 49 per cent of the capital. There is currently no separate licensing regime for commodities spot exchanges.

Other implications of a virtual currency amounting to a good or commodity (under foreign exchange control laws) are discussed in Section X.

D. FDI in Indian virtual currency-based businesses

The *IAMAI* case held that the RBI had jurisdiction over issues relating to virtual currencies, as virtual currencies act as money under certain circumstances. This poses the question of whether virtual currency businesses will be restricted because they are 'other financial services' (OFS) under the NDI Rules. FDI in OFS is permitted without government approval in up to 100 per cent of the Indian entity's equity except where: the financial services activity is not regulated by any financial sector regulator (RBI); only part of the financial services activity is

9. The term deposit includes 'an amount of money received by way of an advance or loan or in any other form, by any deposit taker with a promise to return whether after a specified period or otherwise, either in cash or in kind or in the form of a specified service, with or without any benefit in the form of interest, bonus, profit or in any other form, but does not include . . . [certain enumerated categories]'. The Act provides a schedule of regulated deposit schemes, and all unregulated deposit schemes are prohibited.

10. SEBI/HO/CDMRD/DMP/CIR/P/2016/105.

11. S.O. 3068(E) (Ministry of Finance, Department of Economic Affairs).

regulated; or there is doubt regarding the regulatory oversight. It can be argued that since the IAMAI case clearly lays down that the RBI has jurisdiction over the virtual currency space, there is no doubt regarding the regulatory oversight and, hence, FDI is permitted without government approval.

Additionally, it can be argued that most business models facilitating the buying and selling of virtual currencies can be characterised as e-commerce marketplaces or as miscellaneous software businesses, in which foreign equity investment is permitted up to 100 per cent of the entity's capital, without government approval. The term e-commerce has been defined by the NDI Rules to mean 'buying and selling of goods and services including digital products over digital and electronic networks'. As discussed in Section X, virtual currencies such as Bitcoin and Ether can be characterised as goods or digital products.

IV. Banking and Money Transmission

A. No prohibition on dealing in virtual currencies

The VC Circular prohibited regulated financial institutions (including banks and payment processors) from dealing with virtual currencies or providing services for facilitating any person or entity in dealing with or settling virtual currencies.[12] In the *IAMAI* case, this restriction was set aside by the Supreme Court and is therefore no longer valid in law. Further, the RBI responded to a citizen's Right to Information request stating that there was no prohibition on banks from dealing with virtual currency businesses.[13]

B. Payment and Settlement Systems Act 2007

As many virtual currencies are used as a means of value exchange, questions arise as to whether any authorisation or compliance is required under the Payment and Settlement Systems Act 2007 (the PSS Act). Under Section 2(1)(i) of the PSS Act, a payment system is defined as 'a system that enables payment to be effected between a payer and a beneficiary'. If virtual currency-based systems do form payment systems, any person commencing or operating them will require the authorisation of the RBI under Section 4(1) of the PSS Act.

There is nothing in the PSS Act to exclude virtual currency, since only the term payment is referred to, as opposed to currency, legal tender or money. Therefore, it needs to be judged whether a particular cryptocurrency-based system enables payment to be effected between a payer and a beneficiary, or a person to commence or operate such system.

Arguably, many virtual currencies are not part of a system that enables payment to be effected between a payer and a beneficiary. A user may, for example, merely buy virtual currency using fiat currency for investment purposes and never choose to make any payment with it, and then dispose of it in return for fiat currency. There would be no payment, payer or beneficiary in this connection, and it would resemble the sale and purchase of an asset such as gold. Further, the fact that the value underlying the virtual currency is not backed or guaranteed by the issuing entity or any other party i.e., holders of virtual currencies cannot redeem them for value to the issuer (other than as a sale through ordinary market channels) supports the view that a virtual currency is likely not to be considered a payment system.

Under this view, virtual currencies can be characterised as goods or digital products that people are trading just as they would any other digital products, such as music files or e-books.

Furthermore, owing to the decentralised nature of many virtual currencies, including Bitcoin, the issuers who do commence systems as a matter of practicality cannot be identified. This would mean even if decentralised virtual currencies amount to payment systems, regulators may be unable to pursue the issuers, as they are anonymous. In addition, as is the case with decentralised virtual currencies, entities without power, influence or control over a system are unlikely to be liable for operating it, as the ledger functions independently of any operator.

12. https://rbi.org.in/Scripts/NotificationUser.aspx?Id=11243&Mode=0.
13. RBIND/R/E/20/02104 (27 May 2020).

Even if there is a centralised issuer, that issuer may merely create and release tokens, which are then listed on virtual currency exchanges: the issuer may not play a payment, clearing or settlement role. In this case, a virtual currency can be seen as a licence to use the particular virtual currency ledger and the licence is freely tradable in the open market.

However, a counterargument to the above analysis can be made that a virtual currency blockchain does create a technology to enable the transfer of value from person to person, and hence enables payment to be effected between parties. According to this argument, many virtual currency blockchains may amount to payment systems, requiring the entities commencing or operating them to obtain authorisation under the PSS Act.

According to the RBI's submissions in the IAMAI case, virtual currencies do not amount to payment systems under the PSS Act.

V. Anti-Money Laundering

It is often difficult for regulators to track virtual currency transactions owing to their pseudonymous nature. While wallet identities can be tracked in the blockchain, these wallet identities cannot be easily traced to individual identities. This ability to transfer something of value over the internet that can evade the conventional financial monitoring framework has raised alarm in the eyes of regulators, as they are unable to track the flow of funds that could be used for money laundering purposes.

Currently, know your customer (KYC) and anti-money laundering (AML) norms are set out under a range of different legislation and RBI directions. KYC/AML norms under various laws (e.g., the Prevention of Money-Laundering Act 2002 and the RBI Master Direction – Know Your Customer (KYC) Direction 2016) primarily apply to businesses regulated by the RBI and other regulators such as SEBI. Virtual currency businesses are not reporting entities under these laws. However, effective June, 2022, India's cybersecurity expert body, the Computer Emergency Response Team (CERT) has mandated[14] that "virtual asset service providers", "virtual asset exchange providers" and "custodian wallet providers" (which terms are as yet undefined), must mandatorily maintain: (a) all information obtained as part of Know Your Customer (KYC) processes, and (b) records of financial transactions, for a period of five years.

Even as a matter of self-regulation, it is advisable for these businesses to follow KYC measures on the lines followed by regulated entities, especially if they accept retail users. This would enable such businesses to effectively respond to law enforcement investigations and requests for information, to avoid allegations of being complicit in money laundering or other fraudulent activities.

14. "Directions under sub-section (6) of section 70B of the Information Technology Act, 2000 relating to information security practices, procedure, prevention, response and reporting of cyber incidents for Safe & Trusted Internet" dated April 28, 2022.

VI. Regulation of Exchanges

There is no specific regulation of the activity of virtual currency exchanges and trading platforms, and the functioning of such businesses is regulated by generally applicable corporate, criminal, labour, local and tax laws. As a practical matter, at the time of writing, exchanges face a degree of resistance when accessing the facilities of regulated financial institutions, despite the Supreme Court setting aside the VC Circular. On May 31, 2021, the RBI issued a circular clarifying to its regulated entities (i.e., banks, payment system operators, and others) that the VC Circular could not be cited or quoted from in light of this Supreme Court judgment, but that such entities *"may, however, continue to carry out customer due diligence processes in line with regulations governing standards for Know Your Customer (KYC), Anti-Money Laundering (AML), Combating of Financing of Terrorism (CFT) and obligations of regulated entities under Prevention of Money Laundering Act, (PMLA), 2002 in addition to ensuring compliance with relevant provisions under Foreign Exchange Management Act (FEMA) for overseas remittances."*

VII. Regulation of Miners

There is no law that specifically regulates the activity of virtual currency mining. Mining can be considered a software development activity that generates value in the form of a newly generated virtual currency (sometimes known as the block reward). Fully domestic mining as an activity therefore should only be subject to laws of general application.

While there is no judicial precedent on this issue, FEMA and its regulations may be relevant where the block reward is sent to a virtual wallet address in India and subsequently transferred abroad to a foreign wallet (see Section X). However, an arrangement where an Indian entity only provides the physical mining infrastructure and the newly generated virtual currency is availed directly by a wallet address that is held by a non-resident entity abroad should not attract the export and import-related legal obligations under FEMA. In such a situation, as the virtual currency was never held in India, there is no transfer of a virtual currency from India to a foreign country.

VIII. Regulation of Issuers and Sponsors

A. Securities, deposits and collective investment schemes

If a virtual currency being issued amounts to a security, deposit or collective investment scheme, the applicable legal requirements for such issuance and related ongoing compliance will be triggered.

B. Import and export regulations

The purchase, whether through fiat currency or virtual currency, by Indian residents of virtual currencies issued by international entities is subject to the import and export regulations under FEMA. Cross-border crypto-to-crypto transactions may fall afoul of FEMA from an Indian resident's perspective (see Section X).

C. ICOs

i. Security tokens

Indian entities issuing tokens amounting to securities under Indian law must comply with the relevant obligations under the Companies Act and the SCRA, as discussed in Section II. For example, under Sections 23 and 24 of the Companies Act, if more than 200 people subscribe to a token sale, it may be deemed a public issue that would be regulated by SEBI.[15]

ii. Utility tokens

Issuing tokens in exchange for money or other tokens that merely act as an advance against future services (often known as utility tokens) is workable subject to – for cross-border issuances – the FEMA issues discussed in Section X. However, if such advance is not appropriated against the actual services within 365 days, the amount may be considered a deposit under the Companies Act and the Deposits Rules, as discussed in Section II. Thus, utility token issuers wishing to avoid the restrictions on deposits can contractually ensure that the services are supplied within the required 365-day period.

iii. Payment tokens

These tokens are intended to be used as a means of payment for trading goods or services, as a form of money or value. Unlike utility tokens, they do not give rise to claims for goods or services against their issuer.

From an Indian law perspective, if the blockchain relating to a token forms a payment system requiring authorisation under the PSS Act, then, as discussed in Section III.ii, the entity that commences or operates such a system may be required to be authorised by the RBI.

15. Rule 14(2) of the Companies (Prospectus and Allotment Securities) Rules 2014.

IX. Criminal and Civil Fraud and Enforcement

There are no laws specifically targeting fraud in the virtual currency sector.

However, although it may be a common misconception in India that virtual currency businesses are operating in a completely unregulated space, this is not the case. Various laws of general application, such as the Indian Penal Code 1860 (IPC), the Prize Chits and Money Circulation Schemes (Banning) Act 1978 (the Prize Chits Act), Consumer Protection Act 1986 (CPA) and the Banning of Unregulated Deposit Schemes Act 2019 (the UDS Act), will act against fraudulent business activity. Action has already been taken by authorities under the IPC and Prize Chits Act against fraudulent virtual currency-based businesses. [16]The IPC, the Prize Chits Act and the UDS Act are criminal laws, while the CPA provides a civil remedy.

Sections 415 to 420 of the IPC criminalise cheating. If any person (thus including a virtual currency business) 'fraudulently induces [a deceived person] to deliver any property to any person', and that act causes or is likely to cause damage to the deceived person, he or she can be penalised under Sections 417 and 420. Similarly, the Prize Chits Act penalises schemes for the making of quick or easy money (money circulation schemes) and various types of prize distribution schemes (**prize chits**). The UDS Act prohibits the acceptance of any unregulated deposit (i.e., an amount of money by any deposit taker with a promise to return the same in cash or in kind).

The CPA protects consumers against unfair trade practices, deficiencies in services and defects in goods. Unfair trade practices include false or misleading advertising. As a result, if any virtual currency business makes misrepresentations to consumers or provides deficient services, consumers will have recourse under the CPA.

From an enforcement perspective, as discussed subsequently, the Directorate of Enforcement (ED) has initiated proceedings and inquiries under the Foreign Exchange Management Act 1999 against several leading exchanges in connection with cross-border activity which could be possible on their platforms. Additionally, direct and indirect tax authorities have been active in their inquiries of traders and trading platforms.

16. https://timesofindia.indiatimes.com/city/navi-mumbai/one-coin-fraud-18-in-cop-custody/articleshow/58439996.cms.

1.Forthcoming India chapter in the Virtual Currency Regulation Review

X. Tax

In India, taxes may be on income (direct taxes) or expenditure (indirect taxes). Taxation of virtual currency-related activity can therefore be discussed under two heads: income tax (direct tax) and goods and services tax (GST) (indirect tax).

A. Direct tax

Taxation of income is governed by the provisions of the Income-tax Act 1961 (ITA). Under the ITA, Indian residents are subject to tax in India on their worldwide income, whereas non-residents are taxed on, inter alia, income deemed to accrue or arise in India. Recently, the ITA has widened the scope of 'deemed to accrue or arise in India' by introducing the significant economic presence (SEP) test. A non-resident is considered to have established a SEP in India if the non-resident, inter alia, enters into transactions in respect of goods, services or property with a person resident in India (above specified thresholds) or is engaged in systematic and continuous soliciting of business activities from customers in India. However, non-residents who are residents of a country with which India has signed a tax treaty have the option of being taxed as per the tax treaty or the ITA, whichever is more beneficial.

Under the ITA, effective April, 2022, a 30% tax has been introduced on income from transfer of virtual digital assets. No set off of any losses, including through trading of virtual digital assets would be allowed. Exchanges and buyers have to deduct 1% as tax deducted at source (TDS) when payments are being made to Indian resident sellers. However, despite broad wording, loyalty points or reward points and some other types of digital assets including non-fungible tokens (NFTs) backed by physical assets have been excluded from this 30% tax and 1% TDS.

Another important consideration will be determining the applicability of the equalisation levy (EL) on virtual currency operators. The EL applies at a rate of 2 per cent on the gross value of the services rendered or goods supplied (defined as 'e-commerce supply or service') by 'e-commerce operators' to residents in India.

When interpreting the ITA, the facts and circumstances of each transaction should be kept in mind, because of the ambiguity in the definition of 'virtual digital asset' as well as ambiguities which arise in the taxing and withholding provisions.

B. Indirect tax

The relevant laws concerning GST are the Central Goods and Services Tax Act 2017, the Integrated Goods and Services Tax Act 2017 (the IGST Act) and the respective State Goods and Services Tax Acts, which each have a different jurisdictional ambit.

GST is payable on:

- sales of goods where goods are sold within one state in India;
- sales 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 may be considered as 'goods'. As mentioned in Section I, there is no law that expressly classifies virtual currencies as goods. Although the Supreme Court in the IAMAI case considered whether virtual currencies can be categorised as money or goods (or commodities) and noted that virtual currencies have attributes of both these categories, it did not make any definitive categorisation, leaving the question open. If virtual currencies are categorised as money, then no GST should be applicable as money is excluded from its scope. However, in this case, the Supreme Court acknowledged that virtual currencies are capable of being considered intangible property and goods as well. The characterisation of a virtual currency for the purpose of GST may, therefore, ultimately depend on the context of the transaction.

In addition, if an exchange operator sells a virtual currency in exchange for another virtual currency, the transaction may be considered as barter and GST may be applicable on both transactions as dual supplies.

Under the IGST Act, tax is levied when goods are imported into the country. As virtual currencies are digital goods, unless they are stored in a wallet that is in a physical medium, such as a pen drive or a hard drive, they are unlikely to be subject to customs duties as such duties apply only to the import of tangible goods. Therefore, in practice, IGST would not be levied as the tax mechanism prescribes that IGST shall be applicable only at the point in time when customs is payable on the import of goods into India.

Additionally, GST should be payable with respect to services provided (e.g., services of a trading exchange) in connection with the sale and purchase of virtual currencies. Where a person sells virtual currencies as a hobby, there should be no GST consequences. Sales of virtual currencies where they were initially held as an investment should also attract no GST liability.

Double taxation issues may arise where consumers might be subject to GST while purchasing virtual currencies, and again on their use in exchange for other goods and services that are in turn subject to GST. These issues have yet to have been accounted for by the GST regime.

It should be noted that the above analysis is based on our analysis of GST provisions as they apply generally, and there is no specific government guidance on the application of GST to virtual currencies.

XI. Other Issues

A. Foreign exchange control

Cross-border transfers of virtual currencies, or cross-border remittances for the purchase or sale of the same, raise questions under FEMA.

i. Nature of virtual currencies under FEMA

There is no express classification of virtual currencies under FEMA. The RBI has stated in response to Right to Information requests that it does not classify virtual currencies as currencies under FEMA, no guidelines have been framed on virtual currencies under FEMA and there is no prohibition under law (including FEMA) on banks facilitating the purchase and sale of virtual currencies and cryptocurrencies.[17] Our view is broadly aligned with this, though the answer will depend on the nature of the particular virtual currency being analysed.

The definition of currency under FEMA is an enumerated list, and includes 'any instrument which can be used to create a financial liability'. Virtual currencies are not named under any of the enumerated categories and, in the case of virtual currencies such as Bitcoin, there is no entity that is accepting financial liability in connection with the instrument. The IAMAI case also recognises that virtual currencies have not been classified as currency under FEMA by the RBI. This becomes relevant as FEMA requires that all sales and drawals of foreign currency are made through an authorised dealer of a foreign exchange. If virtual currencies are not foreign currency, they can be bought and sold through regular business entities or peer-to-peer, as they are today. However, for virtual currencies that are the liability of a particular entity (e.g., certain types of stablecoins), the considerations may be different. Stablecoins are discussed in Section X.ii.

Further, virtual currencies may also be considered as goods or software under FEMA. There is no express definition of goods under FEMA. However, according to the Foreign Exchange Management (Export of Goods and Services) Regulations 2015, goods and software are treated alike and software means 'any computer program, database, drawing, design, audio/video signals, any information by whatever name called in or on any medium other than in or on any physical medium'. As virtual currencies are information stored on an electronic medium, it would appear that they fall within the aforesaid definition of software. The RBI's master direction on imports also recognises imports of goods and services 'in non-physical form, i.e., software or data through internet / datacom channels'.[18]

Further, in the case of *Tata Consultancy Services v. State of Andhra Pradesh*[19] in a decision of a constitution bench of the Supreme Court of India, the Court considered whether certain software would fall within the meaning of goods under a state sales tax law. The majority held that the term 'goods' as used in the Constitution of India and under the Sales Tax Act is 'very wide and includes all types of movable properties, whether those properties be tangible or intangible', 'the moment copies are made and marketed, it becomes goods' and 'a transaction sale of computer software is clearly a sale of 'goods' within the meaning of the [relevant Sales Tax Act]', and 'the term "all materials, articles and commodities" includes both tangible and intangible/incorporeal property which is capable of abstraction, consumption and use and which can be transmitted, transferred, delivered, stored, possessed etc.'. In the concurring opinion by Honourable Justice Sinha, a three-part test was laid down for when a software would become goods.[20]

17. RBIND/R/E/20/02104 (May 27, 2020) and RBIND/R/2018/51897 (9 May 2018).

18. Master Direction – Import of Goods and Services (RBI/FED/2016-17/12 FED; Master Direction No. 17/2016-17).

19. Tata Consultancy Services v. State of Andhra Pradesh, (2005) 1 SCC 308.

20. 'Goods may be tangible property or intangible property. It would become goods provided it has the attributes thereof having regard to (a) its utility; (b) [whether it is] capable of being bought and sold; and (c) [whether it is] capable of being transmitted, transferred, delivered, stored and possessed. If software, whether customised or non-customised, satisfies these attributes, the same would be goods.'

While the judgment was not in the context of a virtual currency or the definition of goods under FEMA, it provides useful interpretational guidance, since the term goods has not been defined under FEMA.

Virtual currencies are intangible and are made, marketed and stored on physical servers. They are capable of being bought and sold, as well as transmitted, transferred, delivered, stored and possessed. It may be argued that virtual currencies do not possess utility. However, virtual currencies such as Bitcoin and Ethereum are used for various purposes, including being a store of value, a means of exchange (including for micro-payments) and decentralised applications. Demand for such virtual currencies further indicates their utility. Therefore, based on the text of the law as it stands, virtual currencies such as Bitcoin and Ether are closest in nature to intangible goods or software under FEMA.

As already mentioned, there is no express classification of virtual currencies under FEMA, and the above discussion is only intended to highlight some plausible interpretations as at the time of writing. The IAMAI case holds that virtual currencies are intangible property, which also act, under certain circumstances, as money. This casts a degree of doubt on the interpretation of the classification of virtual currencies under FEMA.

From an enforcement perspective, the ED has initiated proceedings and inquiries under the Foreign Exchange Management Act 1999 against several leading exchanges in connection with cross-border activity which could be possible on their platforms.[21]

ii. Cross-border transactions involving virtual currencies

Cross-border sales of virtual currency by an Indian resident

If a virtual currency is sent from India to somewhere outside India by Indian residents as payment for services rendered or goods (including other virtual currencies) sold by a non-resident entity, then the transaction may be characterised as an export of goods regulated under the Foreign Exchange Management (Export of Goods and Services) Regulations 2015 and the Master Directions on Export of Goods and Services (together, the Export Regulations). The Export Regulations require, inter alia, that the full value of any exports be received only via authorised banking channels (i.e., in fiat currency) and that any set-off of import payments against export receivables only happen through a process facilitated by the authorised bank. This means that cross-border barter would not be permitted. Thus, the cross-border transfer by Indian residents of virtual currencies without receiving fiat currencies through authorised banking channels may be viewed to violate the Export Regulations. However, there are counterarguments to this view, owing to the silence of FEMA on virtual currencies.

The export-related obligations are on the exporter: that is, usually the Indian resident and not the foreign recipient. As such, foreign recipients, unless they specifically target Indian residents, may be able to ring-fence themselves from the above provisions.

21. https://economictimes.indiatimes.com/tech/technology/ed-probing-alleged-foreign-exchange-violations-by-crypto-firms-sources/articleshow/92684235.cms?from=mdr , https://www.business-standard.com/article/markets/enforcement-directorate-issues-notice-to-wazirx-directors-over-fema-breach-121061200067_1.html.

Cross-border purchases of virtual currency by an Indian resident

Outward remittances of fiat currency that are made by an Indian resident for the purchase of virtual currencies like Bitcoin can be argued to be permissible current account transactions under FEMA, as they can be characterised as imports of intangible assets. The provisions under the RBI's directions on import of goods and services allowing for non-physical imports of software lend further support to this view. However, owing to the lack of operational guidance from the RBI on this point, the outward remittance of fiat currency for the purchase of virtual currency is seeing some on-the-ground resistance by banks and other authorised dealers of foreign exchange. Additionally, where the purchase is sought to be made by individuals, it would be subject to conditions under the RBI's Liberalised Remittance Scheme, which restricts outward remittances to US$250,000 per year.

B. Stablecoins

Stablecoins are units of value that are usually issued by an identifiable entity, and, as the name suggests, are intended to be relatively immune to price swings.[22] This is achieved by the stablecoins being 'backed' (though this may not always be the case) by underlying fiat currencies or other traditional assets like gold. A stablecoin issuer may operate by maintaining a reserve of these assets at a given ratio to every unit of cryptocurrency issued. The issuer would generally allow holders of the stablecoin to redeem each stablecoin for its equivalent value in fiat currency. Some examples of such stablecoins currently in the market are TrueUSD and Tether, which are attempting to be pegged in price to the US dollar. Other stablecoins, such as DAI, do not appear to be backed by reserves maintained by any identifiable entity and may require a different analysis. Recent announcements of proposed new stablecoins by various large enterprises show that stablecoins are gathering mainstream corporate momentum.

There is no Indian law that is specifically applicable to stablecoins. The following issues should be analysed:

whether a given stablecoin would amount to currency under FEMA, since the term currency includes any 'instrument by whatever name called that can be used to create a financial liability'; and whether a given stablecoin system would amount to a payment system under the PSS Act (i.e., a system that enables payment between a payer and a beneficiary).[23]

These are interesting questions in the context of Indian law and should be examined carefully on a case-by-case basis, as each stablecoin may have varying legal characteristics.

C. Advertising

Effective April, 2022, the Advertising Standards Council of India (ASCI), a membership-based, self-regulatory body, published guidelines for advertising and promotion of virtual digital assets and services (VDA Ad Guidelines). The VDA Ad Guidelines are self-regulatory in nature and are only binding in the following contexts: (a) to members of ASCI for ads across any medium, and (b) to ads on cable television (for members or non-members). for ads targeted to an Indian audience, advertisers may consider compliance with these guidelines as good practice and also to show legitimate, *bona fide* intent. Additionally, if any social media platform on which the advertisements are displayed are ASCI members, they may require compliance of the ads with the VDA Ad Guidelines. The VDA Ad Guidelines apply to ads for VDA products and services. Amongst other conditions, they provide that:

a. VDA advertisements should carry a disclaimer stating, *"Crypto products and NFTs are unregulated and can be highly risky. There may be no regulatory recourse for any loss from such transactions."* In formats where there

22. e.g., https://www.gdf.io/wp-content/uploads/2019/05/GDF-Stablecoin-Key-Considerations_9-MAY-SUMMIT-DISCUSSION.pdf.

23. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10267&Mode=0.

is a limit on characters, a shortened disclaimer stating *"Crypto products and NFTs are unregulated and risky"* must be displayed followed by a link to the full disclaimer.

b. For ads in 'disappearing stories or posts unaccompanied by text' which are videos less than 15 seconds, the disclaimer should be carried in a "prominent and visible manner as an overlay".

c. Contact information (phone number or email) of the advertiser should be presented in an easily understandable manner.

In addition to the VDA Ad Guidelines, general restrictions under the CPA on false and misleading advertisements would apply to VDA advertisements displayed in India, including the Guidelines for Prevention of Misleading Advertisements and Endorsements for Misleading Advertisements, 2022, introduced in June, 2022. These guidelines are a prescriptive set of do's and don'ts for advertisements, introducing new requirements such as the font and other attributes of disclaimers.

D. Reporting by companies

The Companies Act was recently amended to require all Indian companies to disclose 'details of crypto currency or virtual currency' as part of their annual financial statement reporting, namely:

- profit or loss on transactions involving virtual currency;
- amount of virtual currency held as at the reporting date; and
- deposits or advances from any person for the purpose of trading or investing in virtual currency.

The requirement became effective starting with the financial year ending 31 March 2021.

XII. Looking Ahead

The law in India on virtual currencies is in flux. The Supreme Court's decision in the IAMAI case is positive and affirms the legitimacy of the virtual currency industry, as well as the fundamental rights of stakeholders under the Constitution of India. It confirms that restrictions on virtual currency activity ought to be proportionate – namely, evidence-based, rational and calibrated in accordance with the desired outcome.

Over the course of 2022, certain "crypto-specific" amendments have been introduced to cybersecurity and income tax laws, in addition to a new self-regulatory code, the VDA Ad Guidelines. Enforcement action based on exchange control and tax laws has also seen a significant uptick. Looking ahead, more such amendments may be introduced, and there may also emerge some judicial clarity on certain situations where the enforcement actions are challenged before courts and tribunals. It appears, based on the Ministry of Finance official's statement cited above, that there may also emerge a consultation paper for public comments on a sector-specific regulatory framework. International bodies such as the G20 and the Financial Action Task Force, and leading jurisdictions such as the European Union, Singapore, the United Kingdom and the United States, have all proposed regulatory approaches to address the risks of virtual currencies, so that the benefits are not lost out on.

Experts have opined that blockchain as a system would be rendered either impotent or severely restricted (depending on the blockchain implementation) without any virtual currency or crypto token. These experts include Princeton computer scientist Arvind Narayanan, Ethereum co-founder Vitalik Buterin and author Andreas Antonopoulos. These tokens act as an incentive to blockchain participants to verify transactions and, hence, preserve decentralisation, which is the very breakthrough of blockchain technology. As a result, it may not be a wise policy to try to promote blockchain on the one hand, and then severely restrict tokens on the other.

While virtual currencies entail risks, they also bring with them several benefits, most notably disintermediation and cost savings. Outright restrictions on this technology are impractical and might be relatively straightforward to circumvent. Rather, as with all disruptive technologies, balanced regulation should be adopted to mitigate the risks and promote the benefits. It is our hope that any impending government decision recognises this fact, and adopts a nuanced framework towards this.

Some uncertainty may continue to prevail in India until industry and regulatory understanding matures both domestically and globally; however, our long-term view is positive. The implementation of successful regulatory models in other jurisdictions should also hasten progress towards a balanced regime.

LAW STATED DATE: July 15, 2022

2. Op-Ed - The RBI Stand on Crypto Lacks Balance

March 9, 2022

March 9, 2022

The RBI Stand on Crypto Lacks Balance

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mint

The central bank's recent tirade ignores many facts that weaken its case for an outright crypto ban

A public authority must be neutral and fair-minded. While some concern over cryptocurrency is understandable, recent Reserve Bank of India (RBI) comments likening crypto to a Ponzi scheme and tulip bubble (or worse), and proposing an outright ban, lack balance.

Cryptocurrencies are a platform technology. Like the internet, they can be used for good and bad. The net facilitates child pornography and terrorism (and cryptocurrency itself), but none calls for a ban on it. Many of the criticisms of cryptocurrencies in the RBI deputy governor's speech of 14 February apply analogously to the internet. The net, like cryptos, can also be associated with an anti-establishment ideology. Recall John Perry Barlow's 1996 'Declaration of the Independence of Cyberspace', asking governments to leave the net alone? Cryptocurrency is criticized for being global, decentralized and bypassing intermediaries. But why should that be bad? Email is global, it disintermediates the post office, and that's useful. We're reminded of a 1995 Newsweek article that said this about the net: "We're promised instant catalog shopping—just point and click for great deals. ...So how come my local mall does more business in an afternoon than the entire internet handles in a month?"

No one expects a eulogy to cryptocurrency from RBI, but one would expect it to take a balanced view, so that it does not gloss over the pros and merely highlights the cons.

The contention of the speech that cryptocurrencies cannot meet any need in the finance space can be debunked. By World Bank data, India was the largest receiver of inward migrant remittances in 2021, at $87 billion. But the average cost of sending a remittance to India in 2020 was 5.4%. That translates to over ₹30,000 crore in cost, almost thrice our annual midday-meals budget. This money could be saved, given permissive regulations, since several cryptocurrencies allow cross-border transfers at near-zero cost within seconds. Cryptos have also proven useful in a variety of other contexts, including powering schemes by the World Food Programme and Unicef, and helping raise thousands of crore for covid relief in India. In fact, despite the speech claiming that a crypto ban would not hurt blockchain technology, it fails to note that several 'blockchain' innovations are powered by native cryptocurrencies, such as the Maharashtra State Board of Skill Development's certificate verification programme based on Ethereum, and non-fungible token (NFT) offerings by Indian creators and media houses. While the biggest global institutions and academics, including Turing Award winners, and some of the best Indian minds acknowledge the technological breakthrough of cryptocurrency, RBI still appears to be in disbelief.

The speech also missed some relevant facts. While citing a source estimating the value of crimes globally using cryptocurrencies in 2021 at $14 billion, it did not note that the same source found that illicit activity was just 0.15% of the total crypto transaction volume. The speech also stated that illegal transactions "have been largely filtered out of the formal financial system", but did not cite RBI's own annual report which found that the total quantum of frauds in the Indian banking system in 2020-21 was over ₹1.38 trillion (which exceeds $14 billion). Yet, no one would call it a "Ponzi scheme".

Even if RBI wished to express a strong dislike for cryptocurrency, a ban call ignores our constitutional scheme. It is a basic constitutional principle that the state does not decide private matters for its citizens. The Supreme Court in a well-known case on the right to privacy declared, "The best decisions on how life should be lived are entrusted to the individual." Citizens have the right to participate in a new technology wave and be part of what has come to be known as the Fourth Industrial Revolution. Millions of Indians are doing so. RBI had already made caustic assertions in the Supreme Court defending its 2018 circular on virtual currencies, which the court found lacking empirical basis, disproportionate, and therefore unconstitutional. A long line of cases has held that there is a high bar for the state to ban something. Mere dislike is insufficient. There was no underlying economic data, including any projections, in the speech to show how cryptocurrency is going to actually "wreck" the economy. There was also no reasoning offered on how a crypto ban in India would solve any of the problems cited that regulation cannot solve. The speech asked how a case of mis-selling would be redressed if cryptocurrency were not banned. Some research would have shown that cases of cryptocurrency fraud have already been prosecuted in India. In fact, law enforcement agencies use a combination of publicly-available blockchain logs and information gathered from exchanges and banks to trace culprits. A ban would deprive law enforcement agencies of this information.

An outright ban on cryptocurrency is likely to be excessive and unconstitutional. Even the finance minister in the Winter Session of Parliament stated that a previous draft bill which proposed a ban is being reworked. The chairperson of the committee which made that proposal also now advocates regulation instead of prohibition. One therefore hopes that RBI will reconsider its extreme stance. Meanwhile, India may need to set up a multi-stakeholder regulatory authority—say, a crypto regulatory and development authority—with expertise in computer science, regulation and economics that could help us take the conversation ahead.

– Nishith M. Desai & Jaideep Reddy

3. Tax Hotline

July 8, 2022

3.Tax Hotline

July 8, 2022

Taxation of Crypto-assets

A. 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.

B. 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.*[24], 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.[25] 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 Exchange[26] or Broker[27] (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 places orders on the Exchange platform. The Exchange matches and executes the order and earns in lieu of commission /service fee.	No broker involved	Tax to be deducted by the Exchange on the payment made to the seller (i.e. the owner of the VDA)
			Broker involved, where the broker holds title to the VDA (i.e. the broker is the seller)	Tax to be deducted by the Exchange on payment made to the Broker
			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	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.
			Broker involved, however, the Broker does not hold title to the VDA (i.e. the broker is not the seller)	

24. Uber India Systems (P.) Ltd. vs. Joint Commissioner of Income Tax, [2021] 125 taxmann.com 185 (Mumbai - Trib.)
25. https://www.theweek.in/news/biz-tech/2022/02/07/why-crypto-players-are-confused-about-new-tax-rules.html
26. '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.
27. "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

				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 2 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).

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.

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.

C. 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 pay, 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. [28]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.[29]

D. 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

28. 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.

29. 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).

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.

E. 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.

April 26, 2021

– **Arijit Ghosh & Ipsita Agarwalla**

4. Tax Hotline

February 1, 2022

4.Tax Hotline

February 1, 2022

India Budget 2022: Decrypted

A day before, the Indian Finance Minister (**"FM"**), Nirmala Sitharaman, presented the Union Budget (Budget) of India for the financial year (**"FY"**) 2022-23. With India's economic growth in the current year estimated to be 9.2% (highest among all large economies), the Budget focuses on promotion of the digital economy, clean energy, climate action and private investment with public capital investment.

On the reforms, the Budget proposes to introduce a trust-based governance for ease of doing business in India. In this regard, the Budget has announced that necessary amendments to the Insolvency and Bankruptcy Code, 2016 will be carried out to increase the efficiency of the resolution process and facilitate cross-border insolvency resolution along with reduction in time period for the voluntary winding up of companies from 2 years to 6 months. Further, acknowledging the extent of private equity and venture capital investments in the start-up eco-system, the Budget has announced that an expert committee would be set up to holistically examine the regulatory hurdles and other frictions that prevent further scaling up of such investments. The private equity and venture capital industry has for long been demanding clarity on applicability of GST and income tax on carried interest. Hopefully, with the set up of the expert committee, some of these issues may get resolved. After liberalising the drone sector through the Drone Rules, 2021,[30] the Budget proposes to provide a boost to the drone industry. Start-ups will be promoted to facilitate the Drone Shakti project through varied applications for use of drones as a service (DrAAS). As an independent initiative, the use of Kisan drones in public-private partnerships will also be encouraged for delivery of digital and high-tech services to farmers including crop assessments, spraying of insecticides and nutrients. This should hopefully result in the development of agri-tech for the Indian agriculture sector. The government will also facilitate a fund with blended capital raised under co-investment models through NABARD to finance start-ups for agriculture and rural enterprises.

Further, in light of the space constraints in urban areas for setting up charging stations, a battery swapping policy is proposed to be introduced, and interoperability standards will be formulated to enable this policy. This will encourage private players to develop innovative business models for "battery as a service". The proposed battery-swapping policy and special mobility zones are welcome moves to enable the shift towards sustainable mobility and promote the EV sector.

Furthering the Government's agenda on digitalising the Indian economy, some of the key announcements include introduction of a central bank digital currency, a digital university for enhancing access to educations to students across the country, rolling out the National Digital Health eco-system, which inter-alia, comprises of the unique health identity and launching of the National Tele-Mental Health program to provide quality mental health counselling to the people.

To encourage Defence R&D, the Government also plans to allow design and development of military platforms and equipment to be taken up by private industry in collaboration with Defence Research and Development Organisation. For this purpose, an independent nodal umbrella body will be set up for meeting wide ranging testing and certification requirements.

On the direct tax front, the most significant proposal is the taxation of virtual digital assets. The Budget proposes to tax transfer of virtual digital assets at the rate of 30% irrespective of the period of holding and does not allow for any deduction in respect of expenses incurred aside from the cost of acquisition. Further, gift of such assets will be taxed in the hands of the recipient. Additionally, loss from transfer of such assets cannot be set-off against any other income. Tax is also be withheld at the rate of 1% on the transfer of such assets in certain cases.

30. The Drone Rules, 2021, available at: https://egazette.nic.in/WriteReadData/2021/229221.pdf (Last accessed on February 01, 2022).

4.Tax Hotline

Tax rates largely remain unchanged. However, surcharge on income tax for co-operative societies has been capped at 15% to provide them with a level playing field with companies. Further, the surcharge on long term capital gains on transfer of any type of asset (including unlisted shares) has been capped at the rate of 15%, that is, on par with that of listed shares. Additionally, dividends received by Indian companies from their foreign subsidiaries is proposed to be increased to the rate of 30% instead of the current rate of 15%. Further, the Finance Bill, 2022 (**"Finance Bill"**) proposes to levy withholding tax on perquisites provided to Indian resident taxpayer at the rate of 10% of the value of the perquisite.

For eligible start-ups established before March 31, 2022, a tax holiday for 3 consecutive years out of 10 years from the incorporation date was provided. In response to the Covid-19 pandemic, the Budget proposes to extend this benefit to start-ups incorporated prior to March 31, 2023. Additionally, the concessional tax regime of 15% to manufacturing companies was available should such companies commence manufacturing by March 31, 2023; this date has now been extended to March 31, 2024.

In an effort to streamline the process for tax litigation, certain measures have been introduced to avoid repetitive appeals by the department in the higher courts. This is a positive step towards an efficient litigation resolution framework. Further, the Budget proposes to provide an ability to taxpayers to rectify any errors in their tax return within a period of 2 years from the end of the relevant assessment year.

In a welcome move, the Budget also proposes that where an income tax liability has been modified by an order of an Adjudicating Authority under the Insolvency and Bankruptcy Code, 2016, the Assessing Officer shall modify the demand payable in conformity with such order. This would result in removal of an anomaly whereby there was no mechanism or procedure to reduce the income tax liability to give effect to such orders.

Pursuant to various judicial pronouncements on successor liability, the Budget proposes to introduce a new deeming fiction in the case of a 'business reorganization' wherein the assessments/proceedings (whether pending or completed) on the predecessor entity made during the course of pendency of the scheme/reorganization, are deemed to have been made on the successor.

Developments in relation to the Gujarat International Finance Tec City (**"GIFT City"**) include setting up of foreign universities and an international arbitration centre. On the tax front, tax exemption has been proposed for income of a non-resident from offshore derivative instruments, or over the counter derivatives issued by an offshore banking unit, income from royalty and interest on account of lease of ship and income received from portfolio management services in IFSC. Separately, the Budget proposes to replace the Special Economic Zone Act with a new legislation. However, the fine print of the new legislation is awaited.

A slew of changes has also been made to the scheme under the Income-tax Act, 1961 (**"ITA"**) for charitable organisations, search and seizure related provisions, faceless assessment, allowability of expenditure for the purposes of business or profession and penalty related provisions.

In summary, while this Budget focuses on digitalisation of the Indian economy, it has missed to address number of other key issues such as rules on offshore listing for Indian companies, creating regulatory regime conducive for Special Purpose Acquisition vehicles (SPACs), reduction in tax rates for the salaried / middle class, concessional tax rates for businesses engaged and investing into green technology etc. Further, taxation of virtual digital assets is expected to have a far-reaching impact on the crypto eco-system and it would be relevant to see how the Government further regulates such assets. We have provided below a more comprehensive analysis and further insights on the 2022 Budget proposals. Hope you enjoy reading it.

4.Tax Hotline

A. Tax Rates

The corporate income tax rates for companies, and tax slabs for individuals broadly remain the same for FY 2022-2023. Companies will continue to be taxed at 30% if their total turnover (in the previous year 2020-2021) exceeds INR 4,000 mn (USD 53.5 mn approx), and at 25% if it does not exceed INR 4,000 mn (USD 53.5 mn approx). Concessional tax regimes under Section 115BAA (22% rate for certain domestic companies) and Section 115BAB (15% rate for new manufacturing companies) continues to remain intact. One of the conditionalities to avail the preferential regime under Section 115BAB is for the new company to have commenced its manufacturing or production activities on or before March 31, 2023. The Finance Bill has further extended this date to March 31, 2024.

The above-mentioned rates are exclusive of surcharge and cess, the rates for which continue to remain the same in the case of companies (i.e., 7% – 12%, depending on the tax regime they choose).2 In the case of association of persons (**"AOP"**), their income may be subject to a graded surcharge, which could be up to 37% (if its income exceeds INR 50 mn). The Finance Bill recognizes that as per the terms of several market standard works contracts, individual companies are often compulsorily required to form consortiums (which are treated as AOPs with only companies being its members, not individuals). In such cases, the income of such consortiums are also subject to a maximum surcharge at 37%, which is far higher than the surcharge applicable to the individual companies (which form part of the consortium). To reconcile the difference between surcharge rates for individual companies, and for a consortium formed by such individual companies, the Finance Bill has proposed to cap the maximum surcharge on such AOPs (whose only members are companies) to 15%. This is a welcome move to bring the taxation of AOPs (which are only comprised of companies), at par with the taxation of individual companies.

The Finance Bill has also reduced the Alternate Minimum Tax ("AMT") rate for co-operative societies to 15%. This has been done to bring the MAT rates applicable to co-operative societies, at par with the MAT rates applicable to companies; and provide a level playing field. Further, the surcharge rate to be paid on the tax on income of co-operative societies (with total income between INR 10 mn – 100 mn) has also been reduced to 7%.

B. Taxation of Virtual Digital Assets

While the cryptocurrency space in India has been subject to regulatory resistance and ambiguity, it is has nevertheless boomed in the last year and is estimated to touch USD 241 million by 2030.[31] Indian investors hold crypto assets worth USD 5.3 billion.[32] Further, news reports suggest that India has the highest number of crypto owners in the world at 10.07 crore.[33] The boom in crypto trading can be attributed to a surge in global interest and the Supreme Court decision wherein the Supreme Court set aside, on constitutional grounds, a circular issued by the Reserve Bank of India, which had sought to restrict banking facilities from being offered to participants involved in cryptocurrency transactions. The Supreme Court ruling affirmed the virtual currency exchanges' fundamental right to trade and do business, guaranteed under the Constitution of India.

However, lack of guidance on tax regime created several open issues and grey areas for all participants in the industry. While there is no clarity on the fate of virtual digital assets (**"VDAs"**) in India on the regulatory front, the Finance Bill has proposed the much-awaited taxation regime for VDAs in India. The following changes have been proposed under the ITA with respect to taxation of VDAs applicable with effect from financial year 2022-23:

31. https://economictimes.indiatimes.com/tech/technology/crypto-tech-industry-to-grow-to-241-million-in-india-by-2030-nasscom/articleshow/86478346.cms
32. https://economictimes.indiatimes.com/tech/tech-bytes/about-20-million-indians-jumped-on-to-crypto-bandwagon-in-2021/articleshow/88628547.cms?from=mdr
33. https://www.livemint.com/market/cryptocurrency/india-has-highest-number-of-crypto-owners-in-the-world-at-10-07-crore-report-11634110396397.html

- Definition of VDA;
- Taxing income from transfer of VDAs under section 115BBH at a special rate of 30%;
- Gift tax on VDAs;
- Withholding tax provision on payments for transfer of VDA to a resident.

We have discussed these provisions in detail below.

i. Definition of VDA

The Finance Bill proposes to define VDA under section 2(47A) of the ITA. It seems that the definition of VDA under the Finance Bill has largely draws from the definition under the Draft Banning of Cryptocurrency & Regulation of Official Digital Currency Bill, 2019.[34]

The Finance Bill provides an exhaustive but broad definition of VDA where the following criteria need to be met to qualify as a VDA (irrespective of the terminology or nomenclature):

Necessary Critera:

- any information or code or number or token,
- generated through cryptographic means *or otherwise*,
- can be transferred, stored or traded electronically;

Additional Criteria (one of which needs to be satisfied):

- 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);

Exclusions: Indian currency or foreign currency as defined under Foreign Exchange Management Act, 1999 (**"FEMA"**)[35] is excluded from the ambit of VDA meaning that anything that is Indian currency or foreign currency is automatically not a VDA.

NFT: The definition of VDA also specifically includes a non-fungible token (**"NFT"**)[36] or any other token of similar nature, by whatever name called. While the Finance Bill includes NFTs as a separate category in the definition of VDAs, the Finance Bill provides that definition of the term NFT will be specified by the Central Government by notification. It is also pertinent to note that the Finance Bill empowers the Central Government to notify any other digital asset as a VDA or exclude any digital asset from the definition of VDA. Therefore, from the scheme of the provisions, it appears that the legislative intent is to treat NFTs as a separate class of VDA (based on definitions

34. The Draft Banning of Cryptocurrency & Regulation of Official Digital Currency Bill, 2019 was proposed in the report of the high-level Inter-ministerial committee formed under chairmanship of Secretary, Department of Economic Affairs, to propose specific actions to be taken in relation to Virtual Currencies. The aforesaid bill was supposed to be taken up for consideration by the Lok Sabha in the winter session of the Parliament. However, the bill has not been discussed in the winter session which concluded on December 23, 2021

35. Section 2(q) of FEMA defines Indian currency as, *""Indian currency" means currency which is expressed or drawn in Indian rupees but does not include special bank notes and special one rupee notes issued under section 28A of the Reserve Bank of India Act, 1934 (2 of 1934)"*. Further, section 2(m) of the FEMA defines foreign currency as *""foreign currency" means any currency other than Indian currency"*.

36. Explanation to section 2(47A) of the ITA provides that meaning of NFT may be defined by the Central Government through a notification in the Official Gazette.

to be notified in the future) and not as a something that may fall within the generic criteria set out above. The rationale for such distinctive treatment is unclear for the time being and perhaps the definition of the NFT when notified shall provide more light on the matter.

a. Expansive scope

The proposed definition of VDA in the Finance Bill is very broad, and could include majority of crypto assets currently being traded online. VDAs have various use cases, although, there is no standard classification, certain authorities have classified VDAs based on their functions. For example,

a. *Payment tokens:* certain crypto assets can be viewed as payment tokens which are used as a medium of exchange or goods or services and also as a store of value (in certain cases)[37].

b. *Property Tokens:* certain tokens represent rights in property.

c. *Governance Tokens:* governance tokens allow token holders to exercise control over the ecosystem.

d. *Utility Tokens:* utility tokens facilitate the exchange of or access to specific goods or services etc.

e. *Security Tokens:* crypto assets which fulfil the characteristics of 'securities' as defined under securities laws (although no crypto-assets are today regulated as securities in India) are also likely to be included in the definition of VDAs. While such tokens may represent characteristics of a 'security'[38], however as per the current definition, they may be characterised as VDA only for the purpose of ITA.

The use of words 'information', 'code', 'number' makes the definition of VDA all encompassing. Further the presence of *'or otherwise'* in the phrase "generated through cryptographic means or otherwise", may be interpreted to mean that even the information or code which is not generated through cryptographic means could also be covered under definition of VDA. Due to the wide definition, even credit card / debit card reward points, airline miles, digital vouchers, in-game currencies etc. could potentially be included within scope of VDA, as they may be (i) information / code / number / token generated through non – cryptographic digital means, (ii) which digitally represent value, (iii) represent inherent value or function as unit of account and (iv) transferred, stored or traded electronically. This may have unintended consequences and should be excluded from the scope of VDAs. If one were to take a liberal interpretation of the definition of VDA, dematerialised securities, specifically foreign securities that have shares as underlying security may also get covered resulting in wide ramifications.

The Finance Minister has also announced introduction of Central Bank Digital Currency (CBDC) by the Reserve Bank of India (**"RBI"**) using blockchain starting 2022-23.

37. Example – bitcoin, ether etc.

38. Section 2(h) of the SCRA: ""securities"— include (i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or a pooled investment vehicle or other body corporate; (ia) derivative; (ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes; (ic) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002; (id) units or any other such instrument issued to the investors under any mutual fund scheme; Explanation.—For the removal of doubts, it is hereby declared that "securities" shall not include any unit linked insurance policy or scrips or any such instrument or unit, by whatever name called, which provides a combined benefit risk on the life of the persons and investment by such persons and issued by an insurer referred to in clause (9) of section 2 of the Insurance Act, 1938 (4 of 1938); (ida) units or any other instrument issued by any pooled investment vehicle; (ie) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be; (ii) Government securities; (iia) such other instruments as may be declared22 by the Central Government to be securities; and (iii) rights or interest in securities."

b. Inherent Value

One of the features in the definition of VDA is providing *'..promise or representation of having inherent value...'*. As a market standard, most of the crypto assets issued are accompanied with a whitepaper detailing technical details, concept and roadmap for growth of the crypto asset. Hence, even if a crypto asset does not have inherent value on its issuance, but the issuer promises or represents (maybe through whitepaper or any offer document submitted to SEC for instance at the time of an ICO/Initial coin Offering) that such crypto asset may acquire value in future, then the crypto asset may be considered as a VDA.

At a theoretical level, there have always been criticisms that the crypto assets do not have any inherent value, hence this could be a grey area that creates interpretational issues.

c. Interplay with 'currency'

Indian currency and foreign currency (as defined under FEMA) have been excluded from the scope of VDA. Currency has been defined under section 2(h) of FEMA as,

> *""currency" includes all currency notes, postal notes, postal orders, money orders, cheques, drafts, travellers cheques, letters of credit, bills of exchange and promissory notes, credit cards or such other similar instruments, as may be notified by the Reserve Bank".*

The definition of currency is an inclusive one, and it is unclear whether crypto-assets are covered within in such definition.

While the policy intent is clear that a bright line is being drawn separating currency and VDA, in practice there could be ambiguity with respect to where the demarcation between currency ends and VDA begins. Further, with the proposed introduction of CBDC and developments where countries such as El Salvador have recognised Bitcoin as its legal tender[39], it is quite likely the ambit of Indian and foreign currency may expand, excluding certain items from the scope of VDA.

ii. Taxing income from transfer of VDAs under section 115BBH

The Finance Bill proposes to introduce section 115BBH to provide a special tax rate of 30% for taxing income from transfer of any VDAs. Such income shall be computed without taking effect of:

a. Any deduction in respect of any expenditure (other than cost of acquisition) incurred for such transfer; or

b. Any allowance or set off of any loss.

It is further provided that 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.

It is pertinent to note that the tax rate of 30% is exclusive of surcharge and cess. The super-rich surcharge of 37% applicable on individuals having total income more than INR 5 crores should also be applicable to income earned from transfer of VDAs effectively taking the tax rate to 42.74%. Section 115BBH essentially puts an end to

39. https://www.livemint.com/news/world/el-salvador-becomes-first-country-to-use-bitcoin-as-legal-tender-11631144769412.html

questions on characterisation of income from VDAs in so far as characterisation of such income should not matter as no deductions or set off or carry forward of losses are permitted under section 115BBH.

This is similar to the tax regime that currently exists with respect to taxation of winnings from games. The parliamentary intent appears to be to that transactions in this space are booming and hence need to be taxed at the higher rate of 30%. Prior to this amendment, it was possible to categorise transactions as either trading income and claim expenses or claim long term capital gain rate of 20% based on the facts of the case. However, this special rate of 30% shall impact trading volumes as it increases the tax burden along with the tax certainty it brings.

It is likely that the industry will see a shift in trading patterns, away from seeking arbitrage or small margin large volume trading to more investment style buying and selling from investors.

iii. Gift tax on VDAs

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….*"

The Finance Bill proposes to amend the definition of 'property' to include VDAs. The term VDA has been proposed to be defined under a new section, section 2(47A) of the ITA, and has not been included under the definition of capital asset. By virtue of the proposed amendment, any gift of VDAs should be deemed to be income in hands of the recipient subject to tax at rate of 30% (plus applicable surcharge and cess).

It is however pertinent to note that not all gifts are taxable under section 56(2)(x). Section 56(2)(x) provisions certain exemptions in case of receipt of property (i) from a relative, (ii) under will or inheritance, (iii) from any trust or charitable institution registered under ITA, etc. In such cases, receipt of VDA should also not be taxable. In the cryptoasset markets, it is a common for some crypto projects to airdrop their tokens. Airdrop can be understood as a crypto project sending free tokens en masse to their communities in a bid to encourage adoption and as a means to reward early adopters.[40] In such case, if the value of airdropped VDA exceeds INR 50,000 then it could be taxable in the hands of the recipient. For certain VDAs, one can take a view that such VDAs have been airdropped because a person has used that particular VDA's ecosystem, for which he / she may have incurred certain transaction cost as well, and hence the VDA has not been received without consideration. However, this position depend on valuation and the difference in the amounts paid for the airdropped tokens. Similarly, it is also common for crypto exchanges to issue promotional tokens to their users or offer special tokens as part of the marketing or to incentivise transactions. In case the value of such tokens exceed INR 50,000, tax implications under section 56(2)(x) may be triggered, which is a particular risk where such tokens have an independent market value and trade at a certain value on the market.

iv. Withholding tax provision on payments for transfer of VDA to a resident

The Finance Bill proposes the introduction of section 194S to the ITA. 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.

40. https://www.coindesk.com/learn/what-is-a-crypto-airdrop/

While the aforesaid withholding provision should technically be applicable on the buyer of VDAs and crypto exchanges (marketplace) should not be considered as 'person responsible for paying consideration', the obligation to withhold tax under section 194S may practically be on crypto-exchanges. However, with the advent of decentralised finance and evolution of smart contracts, it is possible increasingly in the future that the 'person responsible for paying consideration' may not be the exchange or the platform, in which case the buyer could directly have a tax deduction exposure.

Further, the withholding tax provision is also likely to be a deterrent to volume trading as volume trading with minimal margins may not feasible considering withholding tax cost on each trade. This is likely to be particularly acute with respect to crypto-crypto transactions where the payments would have to be converted to INR to make the TDS payment. This would create additional currency conversion rate risks or raise operational challenges where users may have to pay INR to be able to receive the crypto into their accounts.

a. Exclusions

The Finance Bill provides that no tax shall be deducted under section 194S in the following cases

a. Where the value or aggregate value of consideration payable by specified person does not exceed INR 50,000 during a FY

b. Where the value or aggregate value of consideration payable by a person other than a specified person does not exceed INR 10,000 during a FY

Practically, the buyer may not have the knowledge of the identity of counter party in a crypto transaction undertaken on a crypto exchange. Even if crypto exchanges were to comply with the provisions of section 194S, they will have to take details from their users to assess whether the users fall under the ambit of specified persons or not. At a practical level, assessing these details may not be possible by the buyer and hence the exchanges may have to step in based on trading data available on their platform.

b. Payment in kind or in exchange of another VDA

Section 194S also obligates the person responsible for paying to a resident any sum by way of consideration for transfer of a VDA to ensure that tax has been paid in respect of such consideration
for the transfer of VDA in case where

i. consideration for transfer of VDA is wholly in kind or in exchange of another VDA, where there is no part in cash; 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 whole of such transfer

Crypto to crypto trading is very common in the crypto ecosystem. It is unclear how the withholding provisions will operate in this case. The obligation on the buyer to discharge tax in case transactions are undertaken in kind seems to be an onerous obligation on the buyers or exchanges and is likely to give rise to cash flow issues. This also creates timing issues with respect to the point in time at which the TDS is to be deducted. The section deems that a credit to the account of a user shall be deemed to be payment, which means that the INR amount for TDS payment should be available with the exchange prior to the credit of the crypto consideration to the seller's account. This would create practical challenges.

c. Interplay with other withholding tax provisions

Section 194S specifically contains a non-obstante clause (section 194S(4)) to provide that if withholding has been undertaken as per section 194S, there should be no obligation to comply with other withholding or collection of tax at source provisions under the ITA. Despite the non-obstante clause, section 194S(8) specifically clarifies that in case where withholding tax provisions contained under both section 194-O and section 194S are applicable on a transaction, then tax should be deducted under section 194S only.

This is a welcome clarification and should put an end to doubts on applicability of section 194 O to crypto exchanges. However, the language of the actual text of the provision in section 194S is a little misleading and potentially suggests the opposite effect. Amending the language to make it clearer by adding "only" as suggested below would avoid any potential issues in the future.

> *"(8) Notwithstanding anything contained in section 194-O, in case of a transaction to which the provisions of the said section are also applicable along with the provisions of this section, then, tax shall be deducted [ONLY] under sub-section (1)."*

d. Power to issue guidelines

Section 194S also contains a provision for the Central Board of Direct Taxes (**"CBDT"**), with prior approval of Central Government to issue guidelines for removing difficulties in context of the said section.

While the proposed regime does not seem to be crypto investor friendly, the mere introduction and recognition of VDAs under the ITA is a welcome move for the industry. Further, while the policy intent for taxing income from VDAs similar to gambling transactions seems to stem from governments discomfort on crypto assets, it is definitely a step in the right direction. It provides clarity on several open questions from an income-tax perspective. Having said this, there are several misses and further clarifications in this regard may be useful:

a. Applicability of equalization levy (**"EL"**) on crypto-exchanges: The Finance Act, 2020 had expanded the scope of EL to apply 2% EL on the amount of consideration received or receivable by an 'e-commerce operator' from 'e-commerce supply or services' made or provided or facilitated by or through it to:

- to a person resident in India
- to a non – resident in certain specified circumstances
- to a person who buys such goods or services or both using internet protocol address located in India. (collectively as **"Specified Persons"**)

Given the broad definition of e-commerce operator and e-commerce supply or services, it may be likely that transactions in VDA by Indian users (especially buyers) on a foreign cryptocurrency exchange could be subject to EL. However, the Finance Bill has not provided any clarity on applicability of EL on foreign cryptocurrency exchanges.

b. Valuation rules: while the Finance Bill provides guidance on manner of taxation, there is no guidance on valuation of VDAs. Valuation of VDAs may be particularly complex given the volatile nature of the asset class. The value determination is particularly tricky with respect to crypto to crypto transactions where the trading rates for each crypto may vary across exchanges within a single day and there could be significant variations across regions. Therefore, determining fair market value of any crypto at a given point in time may not be possible and could lead to disputes. In many instance, this is key to determining the applicability of section 56 for example. Lack of guidance on valuation aspects may create difficulties for taxpayers to comply with the tax provisions.

c. GST provisions: Currently, there is no guidance on the manner in which GST provisions are applicable to transactions in VDAs. The Finance Bill also does not provide any clarity on GST provisions applicable on VDAs. In the recent past, the GST authorities have raided several crypto exchanges in India.[41] Lack of guidance on GST aspects may create several issues on classification of crypto transaction, determination of tax base etc. Clarity on GST provisions should be the next big item in the government's checklist to provide an effective taxation regime for VDAs.

- **International Tax Team**

41. https://www.outlookindia.com/website/story/business-news-dggi-raids-half-a-dozen-crypto-exchanges-in-india-on-gst-evasion-report/407794

5. Blockchain and Education Hotline

September 23, 2021

September 23, 2021

Blockchaining Education- Legal nuances to know

The last few years have seen an unprecedented increase in the use of technology across sectors. The education industry in particular has adapted well to this change. It has integrated technology almost seamlessly into its existing frameworks, both for the delivery of course content and ancillary objectives like administrative tasks and solutions for paying fees. One such new, upcoming and revolutionary technology is blockchain, which offers potentially great solutions to the education sector, for storing certificates, verification of credentials, rewarding students for task completion and intellectual property management, *et al.*

A. What Is Blockchain?

Fundamentally, a blockchain is a decentralised network facilitating transactions between multiple participants usually across different locations. It stores a record of all transactions which occur on it in separate "blocks". It is 'decentralised' because these records are distributed across devices of each participant in the network, and no single entity controls the network, unlike traditional databases. In the case of public blockchains, this data can be accessed by anyone with an internet connection, while private blockchains generally require participants to provide a security key before they can access the blockchain database.

Blockchain offers a unique way for securing data through a decentralized system, and this storage is immutable in nature, meaning that data once stored on the blockchain cannot be removed, tampered with or altered by third parties. For instance, if a document is stored on a blockchain network in block "A", a change made to this document would create an entirely different block "B", making it possible to identify and track all changes made to the document in a secure manner.

Although blockchain came into vogue primarily as part of cryptocurrencies like Bitcoin, the distributed manner of storing information used by blockchain systems has several other uses which go much beyond payments and trading.

B.How Can it Be Used in The Education Sector?

The need to expand use blockchain technology in the education sector has been acknowledged by the government in the National Education Policy, 2020 (**"NEP"**). The NEP lists blockchain as one of the emerging technologies which will likely gain prominence in the education sector in the near future.[42]

i. Student Identity Verification

The permanent and highly secure nature of data stored on the blockchain can be leveraged by schools, colleges and universities to assign an identity to their students. A digital identity which is created for a student on the blockchain could have numerous benefits as well. It would enable schools and universities to easily create a record of a student, and to update their records in a secure manner. This digital identity can also be used by students as an all-access pass to use all virtual resources being offered by an institution. The key advantage of integrating the blockchain to verify student identities is that: (a) it is highly secure compared to digital solutions

42. National Education Policy, 2020 at page 56, https://www.education.gov.in/sites/upload_files/mhrd/files/NEP_Final_English_0.pdf (last accessed on September 21, 2021)

currently in the market; and (b) advancements of students can be easily tracked on the blockchain by studying the newer blocks added on the chain.[43]

ii. Authentication of university degree and certificates

As an example, the Massachusetts Institute of Technology (MIT) has been using blockchain technology to issue certificates to its students since 2015.[44]

In India as well, the use of blockchain in issuing authenticated and secure university certificates is being explored by an initiative called the SuperCert, a collaboration between the NITI Aayog and the Indian School of Business.[45] This platform has been proposed to issue course certificates through a permissioned blockchain architecture. Through SuperCert, each student is assigned a unique identity, which may be used by employers to verify the authenticity of their certificates. This system creates a fingerprint, or a hashed version of the certificates that are uploaded on the blockchain. At the time of verification, the SuperCert system compares this hashed fingerprint of the original certificates with the certificates provided to employers by students. Employers are informed in case any discrepancy is detected in the document provided by students. Such a system ensures that the privacy of students is protected (since employers do not access the original certificates which remain with the university), without compromising the authenticity of certificates.

In a recent development, the Maharashtra Government has announced that it intends to use an Ethereum-based blockchain network to verify student diplomas issued by the Maharashtra State Board of Skill Development (**"MSBSD"**).[46] This marks a first in the country, and it is expected that almost one million certificates will be issued in connection with this project. However, unlike the proposed SuperCert solution which relies on a private blockchain, the MSBSD's use of the Ethereum network to implement verification solutions will be on a public, permission-less blockchain, and interestingly, requires the use of 'Ether' a cryptocurrency / crypto-asset, to function.

Such usage of blockchain to verify certificates streamlines the process of issuing certificates by reducing the procedural formalities around it. It also significantly decreases the expenses incurred by educational institutions in issuing certificates and degrees, while ensuring the security of the document at the same time.[47]

iii. Tokens as Rewards for Task Completion

Another application that blockchain technology has in the education sector is through initiatives like "BitDegree"[48]. BitDegree is an example of a Massive Open Online Course (**"MOOC"**), and employs a "learn to earn" model. It uses the public Ethereum blockchain to build tokens which are used to incentivise its users who learn certain skills. Such tokens have limited uses, such as taking paid courses at educational institutes.

43. Andrew Tobin, Jamie Smith, Self-Sovereign Identity for Higher Education, https://www.evernym.com/blog/self-sovereign-identityhigher-education/ (last accessed on September 21, 2021)
44. Elizabeth Durant, Alison Trachy, Digital Diploma debuts at MIT, https://news.mit.edu/2017/mit-debuts-secure-digital-diploma-usingbit-coin-blockchain-technology-1017 (last accessed on September 21, 2021)
45. NITI Aayog Draft Discussion Paper, Blockchain: The India Strategy, January 2020
46. Ledger Insights, Indian state government launches blockchain educational certificates, ledgerinsights.com/indian-state governmentlaunches-blockchain-educational-certificates/(last accessed on September 21, 2021)
47. Rachel Wolfson, US Education Department Promotes Putting Student Records On Blockchain https://cointelegraph.com/news/useducation-department-promotes-putting-student-records-on-blockchain (last accessed on September 21 , 2021).
48. https://www.bitdegree.org/ (last accessed on September 21, 2021)

iv. Intellectual Property Management

Management of intellectual property in the context of academic research is a key application of blockchain. One such example is "Ledger", a peer-reviewed scholarly journal published online by the University Library System, University of Pittsburgh[49]. It allows users to digitally sign their documents using their bitcoin private keys, and timestamp published manuscripts in the blockchain. Such systems are helpful in automatically tracking the originators of documents and identifying authors. Since data stored on the blockchain is permanent and tamperproof, it is ensured that the integrity of academic research is preserved in a secure manner.

v. Payments

Blockchain technology may also be used by educational institutions to accept cryptocurrency payments from students as a safe and secure alternative to the traditional methods of payment, depending on the regulatory landscape for such methods in the relevant jurisdiction. Several universities across the world have begun to accept cryptocurrencies as a valid mode for the payment of tuition fees.[50]

C. Legal and Regulatory Challenges

i. Privacy and Data Protection

Widescale adoption of blockchain technology will certainly revolutionise the existing framework of the education sector. However, considering that this will involve the storage of highly sensitive personal data of students on a decentralised network, educational institutions should ensure that they take all possible measures to protect the information of their students on the blockchain.

The current regulatory landscape on data protection in India is governed by the Information Technology (Reasonable security practices and procedures and sensitive personal data or information) Rules, 2011 (**"SPDI Rules"**). The SPDI Rules define sensitive personal data to include information such as financial information, medical records, biometric information, etc. Under the SPDI Rules, body corporates which collect, receive, possess, store, deal or handle sensitive personal data of others, in an electronic form, must follow the requirements under these rules, which inter alia include obtaining consent for collecting such data from the providers of information and refraining from retaining the sensitive personal data for longer than required for the purpose of such collection.

The SPDI Rules will likely be applicable where data about student identities and degree certificates is made available on the blockchain. This is because such data is could include , biometric information and financial data, which is treated by the SPDI Rules as "sensitive personal data."

To comply with these requirements, any educational institution seeking to use blockchain networks for document verification will have to inform students (a) that this data is being collected to facilitate future verification, and (b) that data once stored on the blockchain cannot be removed.

The SPDI Rules also mandate that certain reasonable security practices are to be established when sensitive personal data is collected. The SPDI Rules further provide certain examples of standards which would be considered sufficiently reasonable.[51] Where universities are relying heavily on the blockchain to store student data, there is no clarity if such standards under the SPDI Rules can be considered to be satisfied. This is because

49. https://ledgerjournal.org/ojs/ledger/about (last accessed on September 21, 2021)
50. Universities Accept Bitcoin Payments to Ease the Burden on International Students, https://www.analyticsinsight.net/top-universitiesand-schools-accepting-bitcoin-payments/ (last accessed on September 22, 2021)
51. IS/ISO/IEC 27001 standards on Information Technology - Security Techniques - Information Security Management System – Requirements

these requirements under the SPDI Rules have been targeted at systems which store personal data in a single location. However, data on blockchains are stored in a decentralised and distributed manner, meaning that it may be practically impossible to implement these specific security standards in the systems of all participants on the blockchain network.

ii. Spill-over effects of a potential cryptocurrency ban

Recently, it was reported that, pursuant to an Inter-Ministerial Committee recommendation of 2019, the Indian government is considering a ban on dealing with all private cryptocurrencies.[52] However, in this context, the latest statement of the Finance Minister has been that "a futuristic thing can't be shut out".[53] The matter is reportedly pending consideration of the Union Cabinet.[54] A ban on cryptocurrencies may affect digital assets, including those generated by MOOCs such as BitDegree to reward students completing tasks successfully, as well as a pioneering program like that of the MSBSD, as discussed above.

Experts have opined that it may be difficult to separate blockchains from cryptocurrency.[55] This is because blockchains usually reward participants on the chain for expending energy to authenticate transactions by giving them crypto assets. Without such crypto assets, participants on the chain may not be incentivised to validate entries in the distributed blockchain ledger. Hence, a potential ban on cryptocurrencies may severely limit the use of blockchain technology for many of the purposes outlined above.[56]

One such example of a system which may be negatively impacted by a ban on cryptocurrency is that of the recent solution for certificate verification introduced by the Maharashtra State Government discussed above. Since this solution uses Ethereum, a public blockchain which relies on cryptocurrency to function, a crypto ban is likely to impede this initiative and restrict access to the certificates uploaded on the blockchain.

iii. Cybersecurity

Though the data storage and verification on the blockchain has been touted to be one of the most secure means ever devised, cybersecurity vulnerabilities are not entirely eliminated. For instance, there have been several recent situations where hackers gained unauthorised access to information on the chain, and exploited the information contained therein.[57] Though this is technically more difficult to achieve than by hacking traditional centralized systems, blockchain networks do have some vulnerabilities which may be exploited. For example, where blockchain networks rely on a majority consensus mechanism (meaning that a transaction on the blockchain is authenticated if more than 50% of the computing power of the network has authorised it), it would be possible for hackers to take over this system by gaining control of more than half of all the computing power on the network. This could have disastrous results where universities and other educational institutions rely on the blockchain to store and authenticate student information especially where the personal data of students is concerned.

52. The Indian Express, RBI plans and an upcoming Bill: Where are digital currencies headed? https://indianexpress.com/article/explained/cryptocurrency-bit-coin-rbi-7285249/ (last accessed on September 21, 2021)
53. Hindustan Times, On Cryptocurrency, Sitharaman Says 'We Have To Be Cautious But Think It Through', https://www.hindustantimes.com/business/on-cryptocurrency-sitharaman-says-we-have-to-be-cautious-but-think-it-through-101632189095218.html (last accessed on September 22 , 2021)
54. Economic Times, Waiting for Cabinet approval, says FM Nirmala Sitharaman on bill on cryptocurrency, https://economictimes.indiatimes.com/news/economy/policy/waiting-for-cabinet-approval-says-nirmala-sitharaman-on-bill-oncryptocurrency/articleshow/85372886.cms?from=mdr
55. Russia's Crypto Ban Would Stifle Blockchains, https://news.bitcoin.com/buterin-ban-russia-stifle-blockchains/ (last accessed on September 21, 2021)
56. Note: Initiatives like SuperCert may not face this issue, since they rely on a private/permissioned blockchain, meaning that all participants on this chain can be identified by the central authority. The spillover effect may hence be a significant issue only where universities are taking resort to public blockchain structures. See https://www.steptoe.com/images/content/1/8/v2/189187/Cybersecurity-Tech-Basics-Blockchain-Technology-Cyber-Risks-and.pdf(last accessed on September 21, 2021)
57. MIT Technology Review, Once Hailed As Unhackable, Blockchains Are Now Getting Hacked, https://www.technologyreview.com/2019/02/19/239592/once-hailed-as-unhackable-blockchains-are-now-getting-hacked/ (last accessed on September 21, 2021)

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To manage the risks presented by such eventualities, universities should implement strong cybersecurity frameworks including negotiating contractual protections with other participants and undertaking continuous monitoring of the network for security incidents.[58] In addition, such institutions should also ensure that they comply with requirements under the Information Technology Act, 2000 of India and similar laws which require body corporates to report unauthorised uses of computer resources to the relevant authorities within a reasonable timeframe.[59]

iv. Our Take

The blockchain technology offers significant advantages to the education sector across the globe and could significantly decentralise and democratise access to education. In India, particularly, the opportunities offered by blockchain technology in the sector are only beginning to be explored by the government and private players alike. This also offers opportunities for new and allied business models in the education space.

Further, the government has presented a positive outlook towards the use of blockchain technology for improving education in the country under the NEP. We foresee more acceptability and adoption of blockchain in education in the new future.

– **Athira Sankar, Jaideep Reddy & Aarushi Jain**

58. https://www.steptoe.com/images/content/1/8/v2/189187/Cybersecurity-Tech-Basics-Blockchain-Technology-Cyber-Risks-and.pdf (last accessed on September 21, 2021)
59. See Reporting cybersecurity breaches in India – Is it time to overhaul the law?,by Aparna Gaur, Aarushi Jain, Gowree Gokhale and Dr. Mihir A. Parikh, available at https://www.natlawreview.com/article/reporting-cybersecurity-breaches-india-it-time-to-overhaul-law (last accessed on September 21, 2021).

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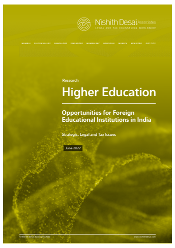

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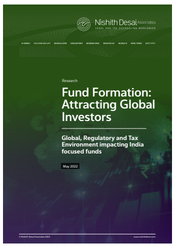

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