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Decoding Taxation of Virtual Digital Assets

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Digital Economy which is the Location-Less Economy is growing multifold with the help of advanced technology. And due to the huge involvement of consumers, it is rapidly evolving. The virtual digital assets being a part of this digital economy have also attained immense recognition in recent times. Like buying and selling of cryptocurrencies, bitcoins, digital tokens, etc. is increasing at a rapid pace. Due to this, various questions were posed before the government that whether these would be banned in India or would be declared illegal, or would be subject to tax?. And then with the Finance Bill 2022, the government cleared most of the doubts and brought the income from virtual digital assets under the purview of the Income Tax Act, 1961 and thereby imposing a tax on such income. This article talks about the meaning of virtual digital assets and their tax implications and some key issues thereof.

Keywords: *virtual digital assets, tax, income tax act, 1961, section 115BBH.*

INTRODUCTION

As the virtual world is growing in its importance, accessibility and technology so are the virtual digital assets. The digital world has not been limited to socializing, shopping, and entertainment only but has been expanded to virtual assets. Interestingly, India has been seeing an increasing number of investors in the virtual digital economy. *India is emerging as one of the world's fastest-growing markets for cryptocurrency trading as it has the second-highest*

cryptocurrency users in the world.¹ Finance Minister Nirmala Sitharaman while addressing the IIT Bombay Alumni Association said “India’s digital economy is expected to witness exponential growth to \$800 billion by 2030 on the back of rising internet penetration and increasing income.”² Thus, with this vast and spectacular growth in the digital economy, the need for its regularisation and taxation arose.

WHAT ARE VIRTUAL DIGITAL ASSETS? (VDA)

Before discussing the provisions relating to the taxation of virtual digital assets, it is essential to understand the term virtual digital assets.

As per section 2 (47A)³ of the Income Tax Act, 1961, “virtual digital asset means-

- a) any information, code, number, or token (not being Indian currency or foreign currency), generated through cryptographic means or otherwise and can be called by whatever name 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 scheme; and can be transferred, stored or traded electronically.
- b) a non-fungible token or any other token of similar nature, by whatever name called;
- c) any other digital asset, as the Central Government may, by notification in the Official Gazette specify.

In simpler words, virtual digital assets mean information, code, token, or number which have digital representation value and which can be traded or transferred digitally. They can be traded, transferred, or stored electronically. They work on cryptographic means or otherwise. Examples of virtual digital assets include audio, videos, cryptos, non-fungible tokens, etc.

¹ ‘India has second-highest cryptocurrency users in the world: Report’ (Deccan Herald, 7 February 2022) <<https://www.deccanherald.com/business/business-news/india-has-second-highest-cryptocurrency-users-in-world-report-1079046.html>> accessed 18 June 2022

² ‘Digital economy to see exponential growth to \$800 bn by 2030: FM’ (Business Standard, 12 March 2022) <https://www.business-standard.com/article/economy-policy/digital-economy-to-see-exponential-growth-to-800-bn-by-2030-fm-122031101141_1.html> accessed 18 June 2022

³ Income Tax Act, 1961, s 2(47A)

Often Digital Assets are known only by cryptos but digital assets are not limited to cryptos only. The definition of digital assets also includes digital tokens, non-fungible assets, etc.

MOST COMMON TYPES OF DIGITAL ASSETS

Payment Tokens- It is a medium of exchange accepted by the public, as payment for goods or services or for the discharge of a debt that is not denominated in any currency. Also, these tokens can be stored, transferred, and traded in electronic mode. Most cryptocurrencies and tokens fall under this category. For example- Bitcoins, Litecoin, Ethereum, Dash, etc. Bitcoin was the first and most popular cryptocurrency owned and traded in India.

Utility Tokens- They provide value to investors in different ways. They offer the right to the users to access future products or services. They are basically promotional tools that have value but cannot be considered money as straightforward as a coin. Examples- Lucky Block (BLOCK), ApeCoin (APE), etc.

Security Tokens- They derive their value from an external, tradeable asset. They are traditional securities in a digital form that live on a blockchain. Backed by real-world real estate, commodities, or, an art having an underlying value. They carry the same characteristics as carried by gold, silver, oil, etc. *Examples- Sia Funds, B cap (Blockchain Capital), and Science Blockchain.*

Assets Tokens- An asset-backed token is a digital token that signifies and derives its value from a real-world asset like money, stock, bonds, real estate, and gold. Examples- Oil Coin which tokenizes barrels of oil held in reserve, Wheat Token Coin for wheat tokenization, etc.

Non-Fungible Tokens- The term non-fungible means each unit has unique qualities. That is no two are the same. For example- Each INR 100 note has the same value as every other INR 100 note. This is because the INR note is fungible. However, for INR 100, US 100 dollar does not hold the same value, we can say these are not interchangeable and therefore they are non-fungible.

The non-fungible token is developed using the same technology used in developing other types of tokens but is mainly used to represent a work of art, photos, videos, audios, collectables, real estate, virtual worlds, memes, GIFs, digital content like posts and tweets, fashion, music, paintings, drawing, political items, film, sports, games, or digital files of value but on the blockchain. It is much easier to understand as compared to Bitcoins or other tokens. In simpler words, NFT is an artwork but on the blockchain. It is like everyone can see it but one can own it. Examples- Jack Dorsey auctioned his first tweet ever on Twitter as an NFT and sold for \$2.9 million.⁷

HOW DOES IT WORK?

What is the fundamental technology powering digital assets? The answer to the question is Blockchain⁴ Technology. A blockchain is a decentralized ledger of all transactions in a network. Using blockchain technology, participants in the network can confirm transactions without the need for a trusted third-party intermediary. It is a distributed database that stores information, electronically in digital format. The goal of blockchain is to allow digital information to be recorded and distributed, but not edited. In this way, a blockchain is a foundation for immutable ledgers, or records of transactions that cannot be altered, deleted, or destroyed.

WHY TAXATION IS NECESSARY?

With the tremendous increase in dealings in virtual digital assets, its regulation, taxation, and prevention of fraud have become a major challenge and issue for the world. The Finance Minister, in her Budget Speech for the year 2022-23, said, *“There has been a phenomenal increase in transactions in virtual digital assets. The magnitude and frequency of these transactions have made it imperative to provide for a specific tax regime.”*

Thus, in India by imposing the tax on virtual digital assets government makes it clear that there will be no banning on the trading of virtual digital assets and all these will be made legal

⁴ ‘NFT of first-ever tweet authored by Twitter co-founder Jack Dorsey a dud in an online auction’ (*The Economic Times*, 19 April 2022) <<https://economictimes.indiatimes.com/magazines/panache/nft-of-first-ever-tweet-authored-by-twitter-co-founder-jack-dorsey-a-dud-in-online-auction/articleshow/90934455.cms?from=mdr>> accessed 18 June 2022

and would be thus subject to tax. Since everything is new and will come into force in the current year only so whether it would be successfully implemented or not will remain a matter of debate and discussion in the future years to come.

HOW ARE THE VIRTUAL DIGITAL ASSETS TAXED?

Section 115BBH⁵ of the *Income Tax Act, 1961* says that Income arising out of the transfer or sale of Virtual Digital Assets will be taxable at 30% (plus applicable surcharge and education cess) without any deduction except for the Cost of Acquisition. This means no deduction of any sort of expenditure will be allowed (except for Cost of Acquisition) from the income arising from the transfer or sale of virtual digital assets. Further, any loss arising from any other sources of income cannot be adjusted from the income from the transfer or sale of VDA. Like if there is a loss from house property or capital gains or business/profession or any other loss arising from any head of income then it cannot be adjusted from the income from the transfer of VDA. Also, any loss arising from the sale of VDA cannot be set off i.e. it cannot be adjusted from any other income. And in future years also it cannot be adjusted from any income. Therefore, in short, we can conclude that any kind of losses cannot be adjusted from VDA income and any loss from VDA cannot be adjusted from any other income. These taxation provisions are applicable with the effect from 1st April 2022. That is any income arising from the sale of virtual digital assets will be taxable on or after 1st April 2022.

TAXABILITY IN CASE OF GIFT OF VIRTUAL DIGITAL ASSETS

*Section 56(2)(x)*⁶ of the *Income Tax Act, 1961* provides that

In case virtual digital assets are transferred for NIL or for inadequate consideration as compared to fair market value (FMV), it is termed as gifting of virtual digital assets and in this case, the difference between the FMV and consideration in excess of INR 50,000 will be considered as income. And this income will be taxable to the person who has received it. Also, this income will be taxable under the head “Other Sources” at a 30% rate of tax.

⁵ Income Tax Act, 1961, se 115BBH

⁶ Income Tax Act, 1961, s 56(2) (x)

TAX DEDUCTED AT SOURCE (TDS) ON VIRTUAL DIGITAL ASSETS

With the effect from 01st July 2022, a person who is responsible for paying any sum to a person who is a resident of India in respect of the transfer of virtual digital assets needs to cut a tax at the rate of 1% on such sum as per section 194S of the Income Tax Act, 1961. And where such amount is deducted under section 194S⁷ of the Act, then there is no need to deduct/collect any tax or other amount under 194O.⁸ By doing this government is ensuring that the payments involving digital virtual assets get reported and taxed. Thus, TDS @ 1% is deducted on the payments which are made to a resident in respect of the virtual digital assets. However, there is no need to deduct TDS if the amount of payment is less than INR 10,000 and in the case of 'specified persons' the threshold limit is INR 50,000.

Where 'specified persons' means:

- a) *being an individual or HUF whose Turnover from Business does not exceed 1 crore rupees or Turnover from Profession does not exceed 50 lakh, during the financial year immediately preceding the financial year in which such virtual digital asset is transferred.*
- b) *being an individual or HUF having income under any head other than the head 'Profit and gains of business or profession.'*⁹

There is one major issue that may arise in deducting TDS is that the buyer and seller are unknown to each other. They both are unaware of each other's identity as the trading of VDA i.e. the buying and selling of VDA happens only on exchanges. Therefore, making it difficult to determine the person responsible for paying the consideration.

SOME KEY POINTS AND ISSUES TO BE NOTED

A 30% flat rate of tax applies to the income earned on the virtual digital assets. Deduction of any expenditures or any loss is not allowed (Except for the cost of acquisition). The method for

⁷ Income Tax Act, 1961, s 194S; Finance Act, 2022, s 60

⁸ Income Tax Act, 1961, s 194O

⁹ Income Tax Act, 1961, s 194S

ascertaining the acquisition cost of virtual digital assets is unclear. As there are many ways for determining the cost of acquisition like the FIFO method, weighted average method, etc.)

Section 115BBH and 56¹⁰ do not provide a method of computation of fair market value of consideration. Even the loss arising out of the virtual digital assets cannot be set off by the income earned from the virtual digital assets. The basic exemption limit benefit is not available from the income of virtual digital assets. However, under section 87A,¹¹ a rebate of up to Rs. 12,500 is available, which is also available from this income of virtual digital assets. Deduction under Chapter VI-A i.e. from Section 80C to 80U¹² which are available to almost every individual is not allowed when the income arises from the transfer of virtual digital assets. In the case where the virtual digital assets are gifted, then the difference between fair market value (FMV) and consideration is treated as income from virtual digital assets. However, FMV is different on different exchanges. Hence it will be a bit challenging and complicated task to determine the FMV. Under what head the virtual digital assets income should be taxed remains unclear as using the words 'Cost of Acquisition', indicates that the income must be taxed under the head 'Capital Gain'. However, the method of taxation and its nature is similar to winning from lottery, puzzles, games, etc. which implies 'Other Sources' head.

CONCLUSION

India has seen a tremendous increase in dealings of virtual digital assets. With this increase, the government has introduced the provisions of taxation of virtual digital assets to bring transparency and revenue to the government and also to curb fraud including money laundering relating to trading in virtual digital assets. Taxation of digital assets will be going to be more interesting, complex, and challenging in the coming time since it involves cross-border transactions and international taxation. Also, with the huge increase in transactions in virtual digital assets, people are becoming more and more aware of VDA and its tax-related issues. Thus, it will also be challenging for the government to successfully implement the tax provisions and thereby regulate the transactions in virtual digital assets.

¹⁰ Income Tax Act, 1961, ss 115BBH and 56

¹¹ Income Tax Act, 1961, s 87A

¹² Income Tax Act, 1961, ss 80C and 80U