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'Bharat Ratna'
Sir M. Visvesvaraya
Founder

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FEDERATION OF KARNATAKA CHAMBERS OF
COMMERCE AND INDUSTRY

Tax on Virtual Digital Assets

[Direct & Indirect Tax Implications]



by

Deepak Kumar Jain

B.Com., FCA., ACS., LLB

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ABOUT FKCCI

The Federation of Karnataka Chambers of Commerce & Industry (FKCCI) was founded by 'Bharata Ratna' Sir M. Visvesvaraya an engineering genius, a visionary, a statesman on May 8th 1916, FKCCI started serving the interests of the business community since its inception. The FKCCI has sought to promote the national interest by way of both public and private sector led, economic growth and has played a catalytic role in policy making at the State and Central level. With a century of service in commerce and industry, it is no wonder that the FKCCI stands as one of the five foremost chambers in the country apart from being the oldest parent chamber of any state in India.

Currently, the membership at FKCCI stands at 3200 direct members and more than 250000 indirect members drawn from all sectors of Trade, Commerce and Industry, spread over Karnataka, including 30 District Chambers of Commerce and 200 Trade Industry Associations.

The Federation is a member of national bodies like FICCI, ASSOCHAM and also the International Chamber of Commerce. Being a member of global trade associations, FKCCI facilitates collaboration of trade between Karnataka's industries and overseas enterprises, and also holds talks with international trade entities. FKCCI's mission is to promote the cause of Trade and Industries in Karnataka, give necessary guidance to members, help frame policies and deliberate on matters of regulation and taxation.



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Lucid explanation of a complex subject

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Foreword

In the wake of growing economy and increase in digital transactions, the acceptance of virtual digital assets, in commercial and non-commercial trade, is being seen, which is also consequent to the technological ease and advancement for receipt and transfer of such assets, without having a mechanism to track them but for the voluntary disclosure by the maker and thereby has also resulted in increased preclusion from regulators. While, the regulator apparently appreciates the technology behind creation of such assets but perceives the potential misuse of such digital assets, in tax evasion and terror funding and we gather information that the regulators are in the process to frame or bring a mechanism that regulates the use of such digital assets.

Despite the unclear regulatory environment, the use and adoption of such assets in commercial trade is very high and is also increasing at very pace. There is lack of clarity on the meaning, scope and implications of transactions in virtual digital currency. My friends, Shri. Deepak Kumar Jain and Shri. Pankaj Sancheti, have done a great job, in preparing this booklet in a concise form, using simple language. It presents the complex subject with remarkable clarity and brevity and is expected to serve as a useful reference material for tax payers, professionals, departmental officers and general public.

We hope that the efforts to create awareness through this booklet would be well received by all. I appreciate and acknowledge the efforts of the authors for their valuable contribution and for the initiative of our GST Committee, under the able leadership of Shri B T Manohar, is highly commendable.

Dr. CA I S Prasad,
President,
Federation of Karnataka Chambers of
Commerce and Industry (FKCCI)

Chairman's Message

Levy of tax on digital assets requires clarity as it is an evolving subject. The views of tax administration and tax experts on the technological aspects also needs clarity in understanding. In order to determine the taxability, one will need to have clear understanding on the manner of creation, use and transfer of such digital assets.

In preparation of this booklet, the authors Shri. Deepak Kumar Jain and Shri. Pankaj Sancheti, have put lot of efforts, which will be a guide to the industry leaders, practitioners and general users in the trade and industry, for the extensive coverage of the subject. I sincerely acknowledge and thank the efforts of Adv. K S Naveen Kumar, Co-Chairman, in supporting the initiative to have a booklet on this subject.

I thank my fellow colleagues, CA Shравan Guduthur, Chairman Central Taxes Committee, CA Chandrashekar B D, Vice-Chairman, GST Committee, Members of GST Committee and other Office Bearers, for their support in the endeavor of the authors.

We consider that this booklet will be well appreciated for its coverage and contribution and GST Committee of FKCCI will always do its best, for the benefit of the Trade, Commerce and Industry.

B T Manohar,
Chairman GST Committee,
Federation of Karnataka Chambers of
Commerce and Industry (FKCCI)

Preface

Virtual digital assets, have over the years, become a currency to parallel to the currency of the regulatory (FIAT Currency) and therefore have not received larger regulatory acceptance. The last decade had witnessed increasing global acceptance of such digital assets, as a mode to trade against goods and services, as dominant form of investment, exchange and as a convenient mode for being a store value, resulting in creation of a global market cap of such assets, which is more than India's current GDP.

The base for its creation and the structure used for transfer of such virtual digital assets, is considered to be technologically supreme, resulting in increased acceptance in commercial and non-commercial transactions. However, deterrence of the regulator to accept and give due recognition to such virtual assets, coupled with complexities in determining their nature and characteristic, has resulted in wide differences of opinion in tax positions. There is increasing demand on the Government to frame parameters that provide its specification, disclosure and determination of its tax liability, consistent in a globally acceptable environment.

This publication is an attempt to provide guidance on understanding the technology behind such digital assets, the use case, the determination of tax under different scenarios, the regulatory behaviour, international perspective and the possible way forward. The publication attempts to provide a lucid understanding to the complex subject and the authors hope that readers would find this useful. The authors acknowledge the contribution of Mr. Ashish Singal, Co-founder & CEO, Coinswitch and CA. Dharshan Shanthamurthy, Founder and CEO, SISA Information Security, for providing their industry perspective on blockchain and virtual digital assets.

We are thankful to Dr. CA I S Prasad, President, FKCCI, B T Manohar, Chairman GST Committee, CA Shravan Guduthur, Chairman Central Taxes Committee, Advocate K S Naveen Kumar, Co-Chairman GST Committee, CA Chandrashekar B D, Vice-Chairman GST Committee and Members of GST Committee of Federation of Karnataka Chamber of Commerce, for lending their valuable contribution in bringing out this publication. We would like to place on record our sincere gratitude to the Federation of Karnataka Chamber of Commerce, for rendering their support in bringing out this publication and for all the initiatives taken by them.

Date: 26-Jun-2022

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Degree/ Qualifications	B.Com., FCA., ACS., LLB Fellow Member of Institute of Chartered Accountants of India; Associate Member of Institute of Company Secretaries of India; Bachelor of Law
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Experience	Deepak has over 21 years of experience on indirect taxes including 9 years in Big 4 accounting firms. Deepak is the founder of Accolet Advisors Private Limited and of the domain/ App 'IndiaGST.com', and provides professional advisory, compliance and litigation support services to Indian as well as multinational companies on excise, customs, service tax, VAT and entry tax and FTP/ SEZ matters.
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Deepak has authored a book on 'Antidumping, Anti-subsidy and Safeguard Measures', published by Institute of Chartered Accountants of India (ICAI) in Mar 2007, a book on 'Goods & Service Tax (GST)', published by Bangalore Chamber of Industry & Commerce (BCIC) in Jan 2010, co-authored a book on 'service tax in a nut-shell', published by Federation of Karnataka Chamber of Commerce & Industry (FKCCI). Deepak was part of the Committee from ICAI which drafted transitional provisions under GST, and adopted for implementation of GST. Deepak is also part of expert committee on indirect taxes of trade associations and bodies including BCIC, FKCCI & KSCAA.

Pankaj Sancheti

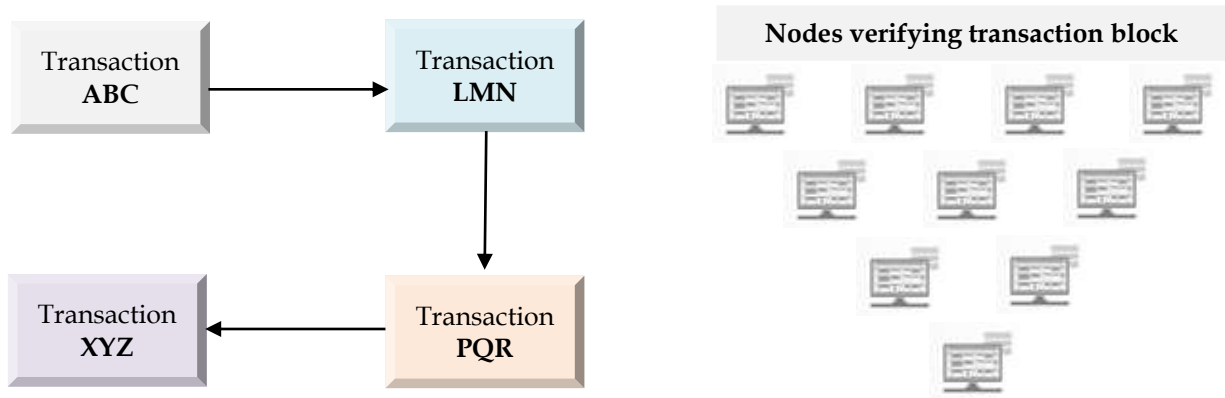
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Experience	Pankaj has over 20 years of professional experience in the field of corporate taxation, transfer pricing and regulatory matters and is the founder Partner for Kevalin Consultants. Pankaj has served wide range of Indian and global companies in different industry verticals and worked and lead Transfer Pricing teams in Big Four consultancy at Bangalore, Hyderabad & Chennai. Prior to founding Kevalin Consultants, Pankaj was Partner at PWC in Chennai and Associate Partner at EY in Hyderabad, where he served ~13 years.
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Pankaj is a regular Speaker and also contributed articles on TP issues. Pankaj is a member of the Executive Committee at Telangana and Andhra Pradesh Tax Bar Association, Ex-Member of Industry Advisory Board at Centre of Management Studies, NALSAR University of Law, Hyderabad, member of Direct Tax Committee at Federation of Telangana & Andhra Pradesh Chambers of Commerce and Industry and chairman of Executive Committee at IFA - India Branch Hyderabad Sub-chapter.

1. Understanding Blockchain technology

- 1.1 Blockchain is considered to be the technology of the future. In the digital environment, it can be applied to any process where people need to access, verify, send or store information securely. It allows people to use this technology, for all most any activity among others, to trace the identity of a person or property, medical records, credit card transactions, loans, etc., or undertake transactions in digital currency such as Bitcoin, Ethereum, Solana, Litecoin, Ethereum, Cardano, and EOS.
- 1.2 Let us consider that there are two ways to store the information i.e. in a centralized place or at multiple places, in a decentralized but distributed manner.
- A centralized record keeping, the record or data is stored at a single or centralized place. The system is opaque and vulnerable to unauthorised access or distribution. In a digital record, if it is a 'master' copy, it would be vulnerable to irreversible alteration or deletion.
 - In a decentralized but distributed record keeping, the record is kept at multiple places, as a copy and such records do not access a central source but they are kept as if they are original copy, in each such distributed but decentralized place. Each time, a record is added or original data is to be altered, the corrected copies get stored in each such multiple place. However, before a record is added or altered, the system would verify and approve the alternation or addition and before adding the record to previous, it would verify the contents, with other records stored at multiple places in the network and should it be same, then gets added to the previous record. It does not replace the data, but adds the information as a chain, so the concept blockchain, in a distributed but decentralized environment.
- 1.3 The blockchain technology is essentially a set of connected blocks or an online ledger. Each block contains a set of transactions that have been independently verified by each member of the network. Every new block generated must be verified by each node before being confirmed, making it almost impossible to forge transaction histories. The contents of the online ledger must be agreed upon by the entire network of an individual node, or computer maintaining a copy of the ledger. The transaction is illustratively explained in the manner given below:



Let us consider that each transaction is recorded in a block

- In the above, let us consider that Block ABC, LMN, PQR and XYZ are records of ownership and transfer of land records and each such transaction is represented by one block
- The blockchain technology ensures that the record is kept as a separate copy in each node, making it impossible for anyone to change the data, unless the same is changed in majority of such nodes
- When the first block is created, it is sent to the nodes to verify
- Upon verification, a record is created and stored on all nodes (systems)
- When a new block is created, say LMN, the nodes verify the same and approve
- The nodes will check the previous block and add LMN to the chain
- When a next block is created, say PQR, the nodes verify the same and approve
- The nodes will check the previous blocks and add PQR to the chain
- Similarly, when a next block is created, say XYZ, the nodes verify the same and approve
- The nodes will check the previous blocks and add XYZ to the chain
- The chain of transactions, hence continues, which links subsequent transactions to the previous.



1.4 Per the above, blockchain uses distributed record ledger, based on consensus mechanism, to execute transactions, to overcome the infirmities in a centralized system. This system of organizing and storing information using blockchain technology, ensures a number of benefits, among others, key parameters are illustrated as below:

Immutability

Since multiple copies of a block chain are kept and managed by consensus across a peer-to-peer network, no one peer can alter past transactions. The record of information therefore become more reliable and authentic.

Security

Blockchain uses cryptography technology, which has the ability to exchange messages that can be read only by the intended recipient.

Verifiability

The combination of transparency and immutability allows users to verify the record i.e. anyone in the world can check for themselves that the rules of the system are being followed. Whilst information cannot be manipulated, it can be easily verified thanks to the size and power of the network.

Resilience

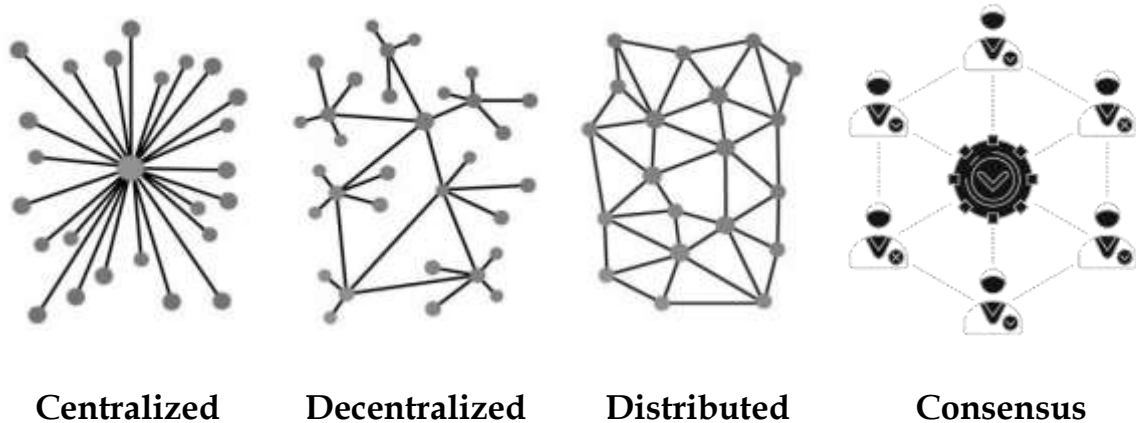
The distributed nature of the ledger makes it resilient. Even if many peers go offline, the information is still accessible.

Transparency with Privacy

The fact that all transactions are broadcast to all peers also makes the ledger transparent. However, the encrypted nature of the transactions means that privacy is also assured.

These benefits can be tuned and blockchain tailored to their specific functions to ensure that issues such as privacy, accountability and transparency are tightly managed.

1.5 Block chain is based on distributed ledger, based on consensus, as against centralized or a decentralized system. Let us understand the terms, illustratively explained, in the manner given below:



- **Centralized:** would mean a system having a single source of authority, control and/or truth,
- **Decentralized:** would mean a system having multi-point source of authority, control and/or truth and the resulting system behavior is the aggregate response
- **Distributed:** would mean a system which shares processing and/or data across multiple nodes, each of them having authority, control and/or truth
- **Consensus:** would mean agreement between different participating nodes or persons with authority

1.6 In summary, as in the words of Prof. Dr. Robby Houben and Alexander Snyersa *“blockchain is a particular type of data structure used in some distributed ledgers which stores and transmits data in packages called ‘blocks’ that are connected to each other in a digital ‘chain’. Blockchain employ cryptographic and algorithmic methods to record and synchronize data across a network in an immutable manner.”*

1.7 There are strong benefits of blockchain technology, which have become an alternate solution to perceived perils in a centralized environment. While the technological development to better the use case, is evolving and is considered to be still nascent for larger use case, the application of the technology is currently being implemented with additional features that enhance the security, the user experience and its utility.

2. Digital currencies using blockchain technology

- 2.1 The most prominent 'use case' for the blockchain technology is the digital currency or digital assets, as they are called. The generation (mining), transfer, store and record, is made on this technology.
- 2.2 Digital currencies use the blockchain technology and rely heavily on authentication tools such as cryptology and data security, to ensure that data transfer between people, is secure and cannot be altered or breached. In its most abstract form, a blockchain with cryptology may be described as a tamper-evident ledger shared within a network of entities, where the ledger holds a record of transactions between the entities and to achieve this tamper-evidence in ledger, blockchain uses cryptographic hash functions.
- 2.3 "Crypto" literally means concealed or secret. "Cryptography" means "secret writing", which is the ability to exchange messages that can be read only by the intended recipient. It gives a unique 64-digit output, of alpha-numeric value, for any given data, using SHA 256 hash algorithm.
- 2.4 While there are many cryptographic hashing algorithms, the SHA-256, which is a patented cryptographic hash function. In encrypting, the data is transformed into a secure format that is unreadable unless the recipient has a key. In its encrypted form, the data may be of unlimited size, often just as long as when unencrypted.
- 2.5 In cryptographic hashing, the hashed data is modified in a way that makes it completely unreadable. It would be virtually impossible to convert the 256-bit hash mentioned above back to its original 512-bit form. So why would you want to create a scrambled message that can't be recovered? The most common reason is to verify the content of data that must be kept secret. For example, hashing is used to verify the integrity of secure messages and files. The hash code of a secure file can be posted publicly so users who download the file can confirm they have an authentic version without the contents of the file being revealed. Hashes are similarly used to verify digital signatures.
- 2.6 Password verification is a particularly important application for cryptographic hashing. Storing users' passwords in a plain-text document is a recipe for disaster; any hacker that manages to access the document would discover a treasure trove of unprotected passwords. That's why it's more secure to store the hash values of passwords instead. When a user enters a password, the hash value is calculated and then compared with the table. If it matches one of the saved hashes, it's a valid password and the user can be permitted access. Cryptocurrencies such as Bitcoin use SHA-256 for verifying transactions.

How secure is SHA-256?

2.7 SHA-256 is one of the most secure hashing functions. In this regard, three properties make SHA-256, very secured:

- (i) It is almost impossible to reconstruct the initial data from the hash value. A brute-force attack would need to make 2^{256} attempts to generate the initial data. Even if one uses Tianhe-2 (MilkyWay-2), the fastest supercomputer in the world, it will take millions of years to crack 256-bit encryption
- (ii) Having two messages with the same hash value (called a collision) is extremely unlikely. With 2^{256} possible hash values (more than the number of atoms in the known universe), the likelihood of two being the same is infinitesimally, unimaginably small.
- (iii) A minor change to the original data alters the hash value so much that it's not apparent the new hash value is derived from similar data; this is known as the avalanche effect.

2.8 The illustrations given below explains the hash results. In this case, the input data passes through SHA 256 Algorithm, where data of any length, is converted into 64-digit alpha-numeric character, in the manner given below:



Input Data	Character length	Output Data [64 digit in length] using hash function
Bharat mata ki jai	18	04bf4e9143d0a17e1c9220d86ee016da0a239e925585978798288b54c61ebf14
Bharat Mata Ki Jai	18	7352f4c91e0e0ce878c6f88571194eaed2aa516a0e5360a09d3b012ad85ef0ea
This string is 88 digit long and has secret password which is meant for defense minister	88	8cd60b6c64262c1f2af44a3cfbebc812424c0bc974365e53cc9864b89a05b9ec

* Calculation of output with help from <https://passwordsgenerator.net/sha256-hash-generator/>

2.9 In terms of the above, with the use of the hash function, any input data (irrespective of its character length), gets a 64-digit output code. The code is encrypted and only the recipient can decode it. It is case sensitive and it is practically impossible for anyone to trace back the data from the output code to the input message or code and therefore makes this system, the most secured mode for transmission of data of information. Blockchain with cryptography therefore makes or gives rise to multiple use cases that can be built using this technology.

3. Flashback: The birth of digital currency

- 3.1 The idea of digital cash appears to have been first introduced by David Lee Chaum, a Computer Scientist and Cryptographer way back in 1983, in a research paper and was actually launched by him in 1990 through a company by name Digicash, which filed for bankruptcy in 1998.
- 3.2 In 1997, a British Cypherpunk by name Adam Back released a plan called hashcash, which claimed to have solved some of the problems that stalled the digital cash project, which had its shortcomings for being accepted by people at large. Many others such as Nick Szabo, who came up with a concept called bitgold, then Wei Dai, who came up with something called b-money, then Hal Finney, another American created his own option, but all of them had a common goal, which, as revealed by Adam Back was as “What we want is fully anonymous, ultra-low transaction cost, transferable units of exchange and if we get that going... the banks will become the obsolete dinosaurs they deserve to become.” However, none of them found large acceptability.
- 3.3 Independently, in the year 1990, two computer scientist by name Stuart Haber and W Scott Stornetta, came out with a research paper on cryptographically secured chain of blocks, using time-stamp, which becomes the source for the current digital currency technology platform. On the problem of centralized person or agency to verify a transaction, in the words of Scott, he said “I realised that if you created a system of interlinked documents with essentially everyone as a witness, then you had, in fact, solved the problem”, which gave rise to consensus mechanism on decentralized platform, for executing a transaction.
- 3.4 Interestingly, during 1991-92, Stuart Haber and W Scott Stornetta, collaborated with Bayer to incorporate Hash Tree or Merkle Trees into the design, which made blockchain more efficient by allowing several documents to be collected into one secured chain of block. The newest record in this chain contained its history. This technology was patented but remained largely unused, until it lapsed in 2004.
- 3.5 In the year 2004, computer scientist Hal Finney introduced a system called Reusable Proof of Work (RPoW) as a prototype for digital cash. This was a significant early step in the history of cryptocurrencies. The RPoW system worked by receiving a non-exchangeable or a non-fungible Hashcash based proof of work token in return, which could be transferred from person to person. This solved the problem of double spending, by keeping the ownership of the tokens registered on a trusted server.


- 3.6 Bitcoin, is the first digital currency. This was invented in the year 2008, by an anonymous person or persons, named Satoshi Nakamoto and introduced in the year 2009, by a white paper entitled "Bitcoin: A Peer-to-Peer Electronic Cash System", through an open-source code. Satoshi Nakamoto improvised the design of distributed blockchain, that could add blocks to the initial chain without requiring them to be signed by trusted parties. The modified Merkle Trees would contain a secure history of data exchanges, which utilizes peer-to-peer network for timestamping and verifying each exchange. It could be managed autonomously without requiring a central authority and these improvements were so beneficial that makes the blockchain technology as the backbone of cryptocurrencies, serving as the public ledger for all transactions in the cryptocurrency.
- 3.7 It would be interesting to understand how Bitcoin became acceptable to people at large. In the white paper, in the words of Satoshi Nakamoto, it is said that:

"..each user of the system could have one or more public Bitcoin addresses – sort of like bank account numbers – and a private key for each address. The coins attached to a given address could be spent only by a person with the private key corresponding to the address. The private key was slightly different from a traditional password, which has to be kept by some central authority to check that the user is entering the correct password. In Bitcoin, Satoshi harnessed the wonders of public-key cryptography to make it possible for a user – let's call her Alice again – to sign off on a transaction, and prove she has the private key, without anyone else ever needing to see or know her private key. Once Alice signed off on a transaction with her private key she would broadcast it out to all the other computers on the Bitcoin network. Those computers would check that Alice had the coins she was trying to spend. They could do this by consulting the public record of all Bitcoin transactions, which computers on the network kept a copy of. Once the computers confirmed that Alice's address did indeed have the money she was trying to spend, the information about Alice's transaction was recorded in a list of all recent transactions, referred to as a block, on the blockchain. [...]

The result of this complicated process was something that was deceptively simple but never previously possible: a financial network that could create and move money without a central authority. No bank, no credit card company, no regulators. The system was designed so that no one other than the holder of a private key could spend or take the money associated with a particular Bitcoin address. What's more, each user of the system could be confident that, at every moment in time, there would be only one public, unalterable record of what everyone in the system owned. To believe in this, the users didn't have to trust Satoshi, as the users of DigiCash had to trust David Chaum, or users of the dollar had to trust the Federal Reserve. They just had to trust their own computers running the Bitcoin software"

- 3.8 Satoshi Nakamoto, created a self-propelling ecosystem, by incentivizing the miners i.e. who verify the transaction, to earn bitcoins in return. This incentive, ensured that the ecosystem had adequate fuel to self-sustain. It is beyond any pale of doubt that irrespective of the metamorphosis (or gene mutation) it has undergone over the years, Bitcoin, as the Adam or Manu of the race of cryptocurrencies, which has been developed by Satoshi Nakamoto, is being accepted as an alternative to FIAT currency and therefore is the most dominant form of digital currency.
- 3.9 In the year 2013, Ethereum, a new digital currency was developed as a public blockchain and launched in the year 2015, by a developer named Vitalik Buterin. Ethereum, unlike bitcoin, is not limited to peer-to-peer technology and has added functionalities, which allow users to record assets such as slogans, or be used as a platform for developing decentralized apps, rather than just being a cryptocurrency. Ethereum, was developed from scratch and has seen larger acceptability for its distinctive technology to be used in smart contracts, by being only next to Bitcoin, in the total market capitalization of digital assets.
- 3.10 There are thousands of digital currencies using blockchain technology in circulation such as Litecoin, Cardano, Tether, USD Coin, Binance, etc., or by prominent institutions, such as Facebook's Diem (formerly called Libra) or JP Morgan's Coin, which have shown the most prominent use case of this technology. All digital currencies other than Bitcoin are currently referred to as 'Altcoin'.

4. The USP: Digital Currency

- 4.1 What makes digital currency unique and what's their selling point? What makes people accept them when such form of currencies is not backed by any Government? Let us consider the below to gain understanding on this.
- 4.2 In the current scenario there are dependencies created on central agencies. In case you need to transfer money, say from New York, to your parents in India, you cannot do this directly and you will need the services of bank, who act as intermediaries or central agencies. In order to transfer USD 1,000, you will experience the below:
- (i) You will need to keep the balance in a bank account
 - (ii) You will give an instruction to the bank to undertake wire transfer
 - (iii) You will need to give reasons for transfer of your own money
 - (iv) You will need to give identity of the recipient and fill all documentations considered necessary
 - (v) The bank in which you have an account, may not be the bank in which your parents in India will have the account
 - (vi) Your bank will take 5 to 7 days, or longer, to move the money from your bank account to the bank account of your parents in India
 - (vii) Your bank and the recipient bank, will deduct charges for sending and receiving money. While transferor bank will charge you upfront, the recipient bank does the adjustment, in the net foreign exchange credited into the recipient bank account. In effect, the money transferred and money received may not be same.
- 4.3 The above is similar to a situation where if you want to shake hand with another, it would be necessary for you to first shake hands with someone, who then shakes hands with the person whom you want to. Since you cannot imagine transferring money directly to the recipient, the process looks to be pretty ordinary. How would it be, if you could transfer the money without the presence or requirement of any intermediary.
- 
- 4.4 In the case of digital currencies, the sender can transfer any portion of the store value of his currency, directly to the recipient without the need of any intermediary. The process is illustrated below:

- (i) Every person having digital currency, will have a public key and a private key. The recipient will share his public key to the sender. Public key is similar to bank account number and private key is similar to password to access the bank account.
- (ii) The sender, using his wallet, will send the amount to the recipient, using the public key of the recipient
- (iii) In the blockchain environment, the information of the sender and the amount held by him, is already recorded as a block.
- (iv) When the sender sends a portion of his store value, a new transaction is added to the block
- (v) Using cryptography and blockchain technology, the transaction is effected in the manner given below:

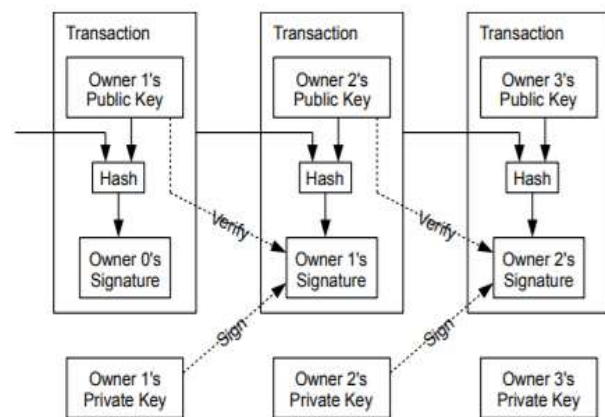
a. Only recipient will be able to receive the amount. Cryptography will ensure that the recipient alone, using his private key will be able to decrypt and have the amount credited into his wallet.

b. The record of all transactions are encrypted and stored on several nodes (computer systems) using blockchain

c. The system where the information is stored, will not know the identity of the sender or the recipient, as the information is encrypted but will be able to independently verify the same, as the same information is stored in multiple systems, which will have to match

d. A chain of the transaction is created by the system when the sender, whose information is already recorded, will link his record to the record of the recipient, by using the public key of the recipient and adding the information to the chain.

e. The recipient will be able to transfer the amount or keep them in his wallet. A new transaction effected by the recipient will add a transaction to the block or create a new block and hence the chain continues.



4.5 In the blockchain environment, the transfer from the sender to the recipient is given effect in about 10 minutes. Also, the cost of transfer, is estimated to be only 10% of the current cost for transfer of money.

- 4.6 Reference is drawn to the benefits illustrated earlier on the blockchain, one can now understand how immutability, security, verifiability, consensus, resilience and transparency with privacy is ensured.
- 4.7 In transactions of digital currency, all the information related to the transaction is captured securely by using algorithms, protected cryptographically, and the data is stored and verified across the entire network of computers. In other words, instead of having a centralized database of the third-party such as banks to certify the transaction taking place, digital currencies use blockchain technology across a decentralized network of computers to securely verify, confirm and record each transaction. In this regard, since the data is stored in a decentralized manner across a wide network, there is no single point of failure, which makes the blockchain more secure and less prone to fraud, tampering or general system failure. This is the USP for acceptability of the technology where transactions are executed directly and consensus mechanism is only to provide confidence, authenticity and provide immutability.
- 4.8 The entire transaction is executed digitally using public or private network emphasizing the best use case on how technology can take away the need for having central agency, who over time, have become authoritative and who monetize the value of dependence on them, often to the disadvantage of the beneficiary.

5. The operating mechanism of digital currencies

5.1 Having understood that digital currencies are nothing but merely an information, code, number or token, having inherent value, which value is not derived by underlying asset, not being stablecoins, but purely by mutual demand and supply. Let us understand the operating mechanism on how digital currencies are generated, received, held and transferred, with an understanding of the stake-holders involved. In doing so, we shall explain operative mechanism for transactions in Bitcoins and where relevant Ethereum, which will provide fair understanding of the operating mechanism of digital currencies, as such.

Quantum restriction

5.2 The creator of bitcoin, set the maximum number of bitcoins which can be mined i.e. produced or brought into circulation, to 21 Million in units and as on May'2022, the total bitcoins mined are a little over 19 Million units. It is considered that every 10 minutes, a new block of bitcoin mined is added to the chain and by the year 2140, all bitcoins would be mined or generated. However, in the case of Ethereum, there is no maximum limit of digital currency, which is set.

Broad categories of currencies and tokens

5.3 There are many types of tokens and currencies in circulation, but most of the them, can be categorized into the following:

Virtual Currency	Security Tokens	Utility Tokens
They are identical in operation to any FIAT currency, which have inherent value, a unit of account and functions as a store of value	They are held for investment purposes and similar to any shares or securities	They are used for exchange of specific goods or services, similar to pre-payment voucher
Bitcoin, Ether, Litcoin, etc., are examples of virtual currency	Sia Funds, Spice, BCAP, tZero, are examples of Security tokens	Storj, which provides access to peer to peer cloud storage network or Basic Attention Token in advertising space

Consensus mechanism - miners

5.4 The network of blockchain is dependent on consensus mechanism. Where everyone participating in the consensus mechanism, has an independent record of all transactions in the history and when a new transaction is to be verified, it gets broadcasted to the entire network and when found correct, the new transaction gets added to existing block, creating a chain. The consensus mechanism ensures immutability and is the backbone of the blockchain. The people who verify the new transaction are referred to as miners. It was very thoughtful of the creator Satoshi Nakamoto, to provide bitcoins to miners, as incentive to people to verify and ensure that there is adequate fuel to ensure continuity of the mining activity. In the case of Ethereum, pre-agreed transaction fees in Ethereum are paid to miners. The commonly used consensus mechanism are explained below:

- **Proof of Work:** It is based on mathematical equations involving computation effort, typically hard to solve. Since multiple nodes would be solving the mathematical problem, it results in high energy consumption, where the reward is credited to the miner who finds the solution first. This system is for verifying transactions in the bitcoin blockchain, and many others.
- **Proof of Stake:** In this system, the miner, also called as 'forgers' or 'stakers', is assigned his shares of validation rights based on the stake they have put into the blockchain. In other words, to validate, the miner has to put his money at stake and hence the term proof of stake. The Stakes can be measured differently (amount of tokens owned, holding period, amount of assets locked in the blockchain as collateral). On successful validation, the Forgers or stakers are credited a transaction fee or new tokens. This system does not use mathematical equations for verification and therefore are considerably more energy efficient than a proof of work mechanism. This system, among others, is used for Ethereum and Peercoin blockchain.
- Other consensus mechanisms exist but are less common, including 'delegated proof of stake' - whereby token holders can vote to designate who they wish to have as block validator and as 'proof of authority'.

Mining Consideration

5.5 The "miner" or forgers' or 'stakers' i.e. the person on the network undertaking the validation of the block to be added, typically under a 'proof of work' protocol or 'proof of stake' protocol or otherwise, is entitled to (i) a mining reward, paid through new tokens, and/or (ii) a protocol transaction fee, which is a percentage of the value of the transaction being processed and is paid from that transaction. The new tokens are therefore brought into circulation by incentivizing miners for undertaking validation process through consensus mechanism.

Distribution of Virtual Currency

5.6 There are popular ways, where virtual currencies are distributed, particularly to new users of currency as incentives to introduce them into this market and also in a manner, where newly generated currencies or tokens are brought into circulation are as below:

- (i) **Airdrops:** It is the distribution of token or coin, without compensation, generally undertaken with a view to increasing awareness of a new token or coin, particularly amongst “influencers”, and to increase liquidity in the early stages of a new token project. For eg. 10 tokens or coins are given free, when you download a video/ photo sharing APP which allows buys, sells, transfers of such coins or tokens, along with viewing or publishing any video or photo.
- (ii) **Initial Token Offering (ITO) or Initial Coin Offering (ICO):** It involves issuance of a new token or coins, which is often issued in exchange for one of the major virtual currencies e.g. Bitcoin, or in some cases, fiat currency. They are used for granting investors access to a platform which allows subscription through use of such tokens or coins, with such investors gaining exclusive right to use the services within an ecosystem. ITO or ICO does not provide ownership rights but merely provides investment opportunity that the tokens or coins exchanged, would give multiple times return on their investment, at a future time.

Storage and transfer

5.7 In order to hold or store a token, users require a wallet. The wallet consists of one, or multiple, digital wallet addresses. For eg. a Bitcoin address is an alphanumeric string such as “6k97u1XqEY72CMnLiaecrnwiRonqRkWVGt”, which is the cryptographic code for a public key, and functions similar to bank account number, used for storing, sending and receiving funds. Anyone wanting to send money, will need the bitcoin address of the recipient. The private key on the other hand is for the wallet owner only, which functions as a password to the crypto wallet and is paired with the public key. Anyone who discovers the private key, will gain access to all the crypto in that wallet and can do whatever they want with it.

5.8 The primary types of digital wallets, to hold crypto-assets, are grouped into as follows:

- **Hot custodial wallet:** This wallet is connected to the internet and therefore referred to as ‘Hot’, and which is managed by a third party (e.g. Trust Wallet, CoinSwitch or Binance), whereby the third-party holds the user’s private keys. In other words, you’re trusting a third party to secure your funds and return them if you want to trade or send

them somewhere else. The custodial wallet requires trust in the custodian that holds your funds, which is usually a cryptocurrency exchange

- **Hot non-custodial wallet:** This wallet is also connected to the internet, the user downloads a software application to create the wallet on their own computer or mobile device and retains control of his private keys. Examples of this wallet include ZenGo, Trezor One, Electrum, Ledger Nano X.
- **Cold hardware wallet:** a physical device (similar to a USB/flash drive) that is kept offline (i.e. “cold”) but which can be connected to an online computer or mobile device, when needed (e.g. Trezor, Safepal, Ledger Nano X).
- **Cold paper wallet:** pieces of paper on which the digital address and private key are recorded. They can be digitally generated on an offline computer and printed, before the computer is re-connected to the internet. (e.g. Walletgenerator.net)

When executing a transaction, the sender “signs” the transaction using their private key. Using the public key, the receiver, as well as all the other users on the network, can verify the private key to confirm that the right sender indeed approved the transaction and has the funds available to make the transaction. Transactions are validated and then compiled into a block with other transactions, time-stamped and ‘confirmed’, adding the blocks in chronological order to the blockchain ledger.

Intermediaries

5.9 Digital currencies can be transferred directly without the help of intermediaries. However, in order to find potential token purchasers or sellers, a user may use a virtual currency exchange or an over the counter (OTC) broker through a peer-to-peer network or a third-party intermediary or through an ATM

- **Virtual Currency Exchanges:** an online service allowing customers to trade virtual currencies for other assets, either fiat currency or other crypto-assets, which may be custodial or non-custodial exchanges.
- **Over the Counter (OTC) broker:** refers to a process of brokering an “off-market” exchange of tokens in exchange for either fiat currency or for other crypto-assets.
- **Bitcoin ATM:** offer users the option to buy and exchange cryptocurrencies with fiat money, over an ATM, similar to currency exchanges

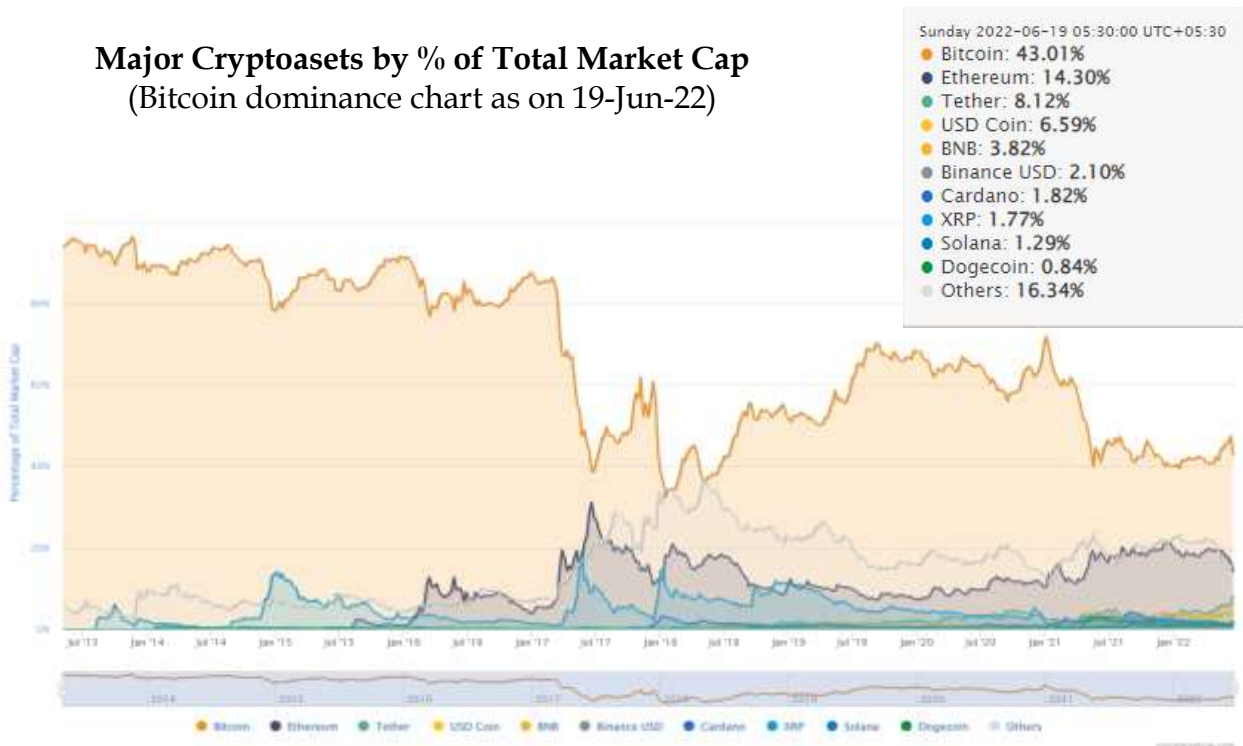
6. Growth and Market-cap of digital currency

- 6.1 There are several digital currencies in circulation, the growing market cap, shows that their acceptance, is seen primarily in the last 5 years. The trust vested in FIAT currencies (USD, EURO, YEN, INR, etc.) flows from the fact that such currencies are issued by a central authority, backed by Government, unlike cryptocurrencies, which is founded on the underlying technology i.e. blockchain technology.
- 6.2 It is undoubted that an effective form of money must function as a medium of exchange, have a store of value and be a unit of account. The below summarizes the utility function of digital currencies, to be regarded as money:

Store of value	It is important that to be money, it has to have a store of value and which value, is retained without higher risk of its diminution or devaluation. Cryptocurrencies in general, since its introduction, have seen significant fluctuation in value as they are controlled by pure demand and supply and are not controlled or regulated by a central agency. However, the emergence of stablecoins (price-stable digital assets with underlying collateral structures) strengthens the use case of digital currency as a store of value. Pegging cryptocurrency value to an underlying asset (fiat money, crypto, or a commodity) has brought a reliable store-of-value functionality to cryptocurrencies.
Medium of exchange	Money must be widely accepted form for payment or exchange, where both sides in a transaction must share the perception of its value. During initial years, had perceptible hesitance in acceptance. However, the rapid expansion and adoption of digital currency markets indicates a growing acceptance of cryptocurrency on both the individual and the institutional level.
Unit of account	In order to function as a unit of account, money must be able to effectively denominating the value of different products and services throughout the economy in relation to each other. For eg. 1 BTC is more valuable than 400 Grams of gold but less than 2.5 Kilograms of Silver. Further, to be a valid unit of account, each unit of money must also be divisible. For example, a fiat dollar can be broken down into quarters, dimes, nickels, and pennies, while Cryptocurrency are well suited towards divisibility because it is digital in nature. For eg. BTC is divisible into units as small as one satoshi, which is one hundred millionth of a single bitcoin (1/100,000,000).

- 6.3 While the value of physical money (notes and coins) i.e. FIAT money, in circulation is estimated to be over USD 40 Trillion, the digital currencies are the fastest growing asset class, with a market cap of over USD 1.2 Trillion as on May'2022 and having close to USD 3 Trillion in Nov'2021.
- 6.4 Bitcoin is the most popular and valuable cryptocurrency. It is said that there are over 19 Million bitcoins (of the 21 Million bitcoins stated, as to ever exist), which are in circulation, with every 10 minutes, a new bitcoin being added. In wake of Bitcoin's success, many other cryptocurrencies, known as "altcoins" have been launched, while some of these are clones of Bitcoin, others are new currencies that are built from scratch such as Solana, Litecoin, Ethereum, Cardano, and EOS. It is considered that as on November 2021, the aggregate value of all the cryptocurrencies in existence, is estimated to be over USD 2.9 trillion, with Bitcoin representing approximately 41% of the total value. Ironically, as on 19-Jun-22, the aggregate value of all cryptocurrencies as in existence, is has sharply fallen to estimated USD 0.9 trillion, with Bitcoin representing about 43% and Ethereum representing about 14% of the total value:

Major Cryptoassets by % of Total Market Cap
(Bitcoin dominance chart as on 19-Jun-22)



* Note:

The above graph shows the individual proportions of the largest ten cryptoassets relative to the total market capitalization of all assets. Since Bitcoin was the first asset, it has remained the largest by market cap, which is why it's dominance in the market is a number that many people follow. The above chart includes tokens and stablecoins.

- 6.5 Interestingly, cryptocurrency derive its intrinsic value from its native blockchain, where monetary policies are transparent and written into the protocol's codebase. While cryptocurrencies often have no fiscal policy, it is important to remember that their monetary policies are subject to the governance and consensus mechanisms of the protocol itself, rather than a single, central authority. Fiat currency are the dominant form of money, but cryptocurrencies may very well represent the next step in the evolution of money, in digital form.
- 6.6 In the year 2018, it would be interesting to note that as many as 983 Initial Coin Offerings were issued, through which funds to the tune of USD 20 billion were raised and this indicates how virtual currencies are being accepted by people at large and how dominant the industry would become, despite not having required legal and regulatory support from various developed and developing economies.

7. International perspective on digital assets

- 7.1 There is no international consensus on the treatment, meaning and regulation of digital currencies and assets. The governments and money market regulators through-out the world, realizing that prominence to virtual currency will lead to diminishing value of FIAT currency, have gone into denial mode holding that they do not have status of legal tender, as they are not backed by a central authority.
- 7.2 Let us summarize the meanings assigned to them by some of the prominent regulators across the globe:
- (a) The International Monetary Fund, the Financial Action Task Force, the European Central Bank, the Financial Conduct Authority of the United Kingdom, Internal Revenue Service of the United States, Department of Treasury and the Canadian Revenue Authority, treat virtual currencies as 'digital representations of value'.
 - (b) The European Central Bank goes a step further by describing virtual currency as 'a type of unregulated digital money'.
 - (c) The Internal Revenue Service of the United States, Department of Treasury has recognized that a virtual currency can function in the same manner as 'a country's traditional currency'.
 - (d) The Securities and Exchange Commission, USA also recognizes that 'virtual currencies are intended to perform many of the same functions as long-established currencies such as US dollar, Euro or Japanese Yen'.
 - (e) The wing of United States Department of Treasury, namely Financial Crimes Enforcement Network considers virtual currency 'as a medium of exchange that operates like a currency in some environments, though it may not have all the attributes of a real currency'.
 - (f) Similarly, State of Liechtenstein considers digital currencies 'as monetary units which can be exchanged for legal tender and used for purchase goods or services, thereby assuming the character of legal tender'.
 - (g) The German Federal Financial Supervisory Authority treats virtual currencies 'as units of account and consequently as financial instruments'.
 - (h) Luxembourg has taken an official position that 'crypto currencies are actual currencies'.

- (i) Some of the states in the Unites States of America have passed laws recognizing virtual currencies as electronic medium of exchange
- (j) Many countries such as China, Nepal, Bahrain, Kuwait, Bangladesh, Vietnam, Egypt, Maldives, etc., has either put explicit or implicit ban on cryptocurrencies
- (k) El Salvador (small country of Central America on the banks of the Pacific Ocean) and Central African Republic, are the only two nations, which recognize certain digital currencies as legal tender

7.3 While it is true that virtual currencies are not recognized as legal tender, it is as much true that they are capable of performing some or most of the functions of real currency. It is also true that their technology, is far superior and their acceptability, despite regulatory deterrence, has seen progressive growth. It would be good to regulate them through a low tax regime rather than cause evasion by a highly regressive tax, without having any ability to detect and therefore be devoid of its purpose.

8. International case-laws on digital assets

- 8.1 It may be interesting to analyze the interpretations on the characterization of Digital Assets, in foreign jurisdictional courts, as is relevant, to fully comprehend the subject.
- 8.2 In a case of soliciting illicit investments in Bitcoin related opportunities from a number of lenders and defrauding them to the tune of 700,000 BTC in funds, the Sherman Division Eastern District Court of Texas opined in **SEC Vs. Tredon Shavers**, [Case No. 4: 13-Cv-416 (August 6, 2013)] that "*It is clear that bitcoin can be used as money. It can be used to purchase goods or services and as Shavers stated, used to pay for individual living expenses. The only limitation of bitcoin is that it is limited to those places that accept it as currency. However, it can also be exchanged for conventional currencies such as the US dollar, euro, yen and Yuan. Therefore, bitcoin is a currency or form of money...*"
- 8.3 In a case involving offences by designing, launching and administering a website called 'Silk Road', as an online marketplace for illicit goods and services, the United States District Court, Southern District, New York, in the case of **United States Vs. Ulbricht** [31F. Supp. 3d 540 (2014)], held that "*Bitcoins carry value-that is their purpose and function-and act as a medium of exchange. Bitcoins may be exchanged for legal tender, be it US dollars, euros or some other currency*".
- 8.4 In a similar case, where the defendants were charged with the operation of an underground market in the virtual currency bitcoin via the website 'Silk Road', the United States District Court, Southern District, New York, in the case of **United States Vs. Faiella** [39F. Supp. 3d 544 (2014)], relying on the decision in the case of Tredon Shavers case, held "*bitcoin clearly qualifies as money or funds under the plain meaning definitions. Bitcoin can be easily purchased in exchange for ordinary currency, acts as a denominator of value and is used to conduct financial transactions*".
- 8.5 In relation to the initiation of public administrative proceedings to determine whether the defendant was engaged in violation of the provisions of Commodity Exchange Act and the Commission's Regulations by operating an online facility named Derivabit offering to connect buyers and sellers of Bitcoin option contract, the Commodity Futures Trading Commission (CFTC) took a view **In re Coinflip, Inc**, [CFTC Docket No. 15-29 dated 17-09-2015] that virtual currencies are "commodities". Similar view was taken by the same court in the matter of **TeraExchange LLC** [CFTC Docket No. 15-33 dated 24-09-2015] and in the matter of **BFXNA Inc.**, doing business as 'BITFINEX' [CFTC Docket No. 16-19 dated 02-06-2016].

- 8.6 A similar view was taken by United States District Court, District of Massachusetts in **Commodity Futures Trading Commission Vs. My Big Coin Pay, Inc. et al.** [18-Cv-10077-RWZ dated 26-09-2018], holding that since there is, futures trading in virtual currencies, they constitute ‘commodity’ within the meaning of the Statute.
- 8.7 In a case involving a person who advertised sale of Bitcoins in an online platform run by a peer-to-peer Bitcoin exchange by name *Localbitcoins.com*, the Court of Appeal reversed the decision of the Circuit Court in the case of **State of Florida Vs. Michell Abner Espinoza** [264 So. 3d 1055 (2019)], held referring to Jun’2014 Report of FATF titled “Virtual currencies: key definitions and potential AML/CFT risks” that given the plain language of the Florida statutes governing money service businesses and the nature of bitcoin and how it functions, the defendant was acting both as a payment instrument seller and engaging in the business of a money transmitter. The court concluded that virtual currencies are payment instruments and hence a person dealing with the same is in money services business. It held that *though Bitcoin does not expressly fall within definition of “currency” found in the statute, the court held that Bitcoin would certainly fall under the definition of a payment instrument.*
- 8.8 In **AA Vs. Persons Unknown** [[2019] EWHC 3556 (Comm)], involving a case where the IT system of a Canadian insurance company was hacked through a malware called Bitpaymer, which encrypted all the data of the company. A ransom equivalent of USD 950,000 in Bitcoin was demanded by the hackers for decryption. Thereafter, the insurance company engaged the services of a blockchain investigation outfit known as Chainalysis Inc., which found that of 109.25 Bitcoins transferred as ransom, 13.25 Bitcoins (approximately worth USD 120,000 at the time) had been converted into an untraceable fiat currency. The remaining 96 Bitcoins had been transferred to a “wallet” linked to a Virtual Currency exchange known as Bitfinex (registered in British Virgin Islands). The insurance company then sued the Virtual Currency Exchange before the High Court. The core issue before the court was whether crypto currencies constituted a form of property capable of being the subject matter of a proprietary injunction. The English High Court held *that virtual currencies are neither choses in action (not embodying a right capable of being enforced in action) nor choses in possession (being virtual and incapable of being possessed). But virtual currencies still be treated as property, as held in the decision of House of Lords in the case of National Provincial Bank Vs. Ainsworth* [[1965] 1 AC 1175 at 1248] *where the court opined that crypto currencies satisfied the definition of ‘property’ to the effect that it must be “definable, identifiable by third parties, capable in its nature of assumption by third parties, and have some degree of permanence or stability”.* The House of Lords further noted that *“crypto currencies are not legal tender in the sense of being a regulated currency*

issued by a government but do have the fundamental characteristic of intangible property as being an identifiable thing of value”.

- 8.9 The ruling of the European Court of Justice in **Skatteverket Vs. David Hedqvist**, [0 Case C-264/14 dated 22-10-2015] was with particular reference to the identity of virtual currencies. ECJ was in this case asked to decide a reference from Supreme Administrative Court, Sweden on whether transactions to exchange a traditional currency for the 'Bitcoin' virtual currency or vice versa, which Mr. Hedqvist wished to perform through a company, were subject to value added tax. The Court held that the transactions in issue were entitled to exemption from payment of VAT as they fell under the category of transactions involving 'currency [and] bank notes and coins used as legal tender'. In this regard, Article 135(1)(e) EU Council VAT Directive 2006/112/EC is applicable to non-traditional currencies i.e., to currencies other than those that are legal tender in one or more countries in so far as those currencies have been accepted by the parties to a transaction as an alternative to legal tender and have no purpose other than to be a means of payment. The court accordingly concluded that virtual currencies would fall under this definition of "non-traditional currencies".
- 8.10 Thus depending upon the text of the statute involved and depending on the context, various courts in different jurisdictions of the globe have identified virtual currencies to belong to different categories ranging from being a 'property' or 'commodity' or 'non-traditional currency' or 'a payment instrument' or 'money' or 'to funds'.

9. Indian Government on Crypto

- 9.1 There appears to be unanimity of opinion among all the regulators and the governments of various countries that though virtual currencies have not acquired the status of a legal tender, they nevertheless constitute digital representations of value and that they are capable of functioning as (i) a medium of exchange; (ii) a unit of account; (iii) a store of value. Let us look at certain of the important developments, from the Government of India's perspective to digital currencies.
- 9.2 On 24-12-2013, a Press Release was issued by RBI cautioning the users, holders and traders of virtual currencies about the potential financial, operational, legal and customer protection and security related risks that they are exposing themselves to. The Press Release noted that the creation, trading or usage of Virtual Currency, as a medium of payment is not authorized by any central bank or monetary authority and hence may pose several risks narrated in the Press Release.
- 9.3 On 27-12-2013, newspapers reported the first ever raid in India by the Enforcement Directorate, of 2 Bitcoin trading firms in Ahmedabad, by name, rBitco.in and buysellbitco.in. This was stated to be India's first raid on a Bitcoin trading firm and the second globally, after Federal Bureau of Investigation of the United States of America conducted a raid in October of the same year.
- 9.4 The Committee on Payments and Market Infrastructure, which is a body corporate established under the laws of Switzerland and owned by 60 Central Banks of different countries including RBI, in its report issued in Nov'2015 on digital currencies, said although digital currencies typically do have some, but not all the characteristics of a currency, they may also have characteristics of a commodity or other asset. Their legal treatment can vary from jurisdiction to jurisdiction.
- 9.5 In January 2017, the Institute for Development and Research in Banking Technology (IDRBT) established by RBI in 1996 as an institution to work at the intersection of banking and technology submitted a Whitepaper on "Applications of blockchain technology to banking and financial sector in India".
- 9.6 On 01-02-2017, RBI again issued a Press Release cautioning users, holders and traders of virtual currencies. On similar lines, on 25-07-2017, a report of the Inter-Disciplinary Committee was submitted, containing recommendations providing visible and clear warning should be issued through public media informing the general public that Government does

not consider crypto-currencies such as bitcoins, as currencies. It also recommended to constitute a committee with members from Department of Economic Affairs, RBI, SEBI, Department of Revenue, Department of Legal Affairs, Consumer Affairs, and Ministry of Electronics and IT, to suggest whether any further actions, including legislative changes, are required to make possession, trade and use of crypto-currencies expressly illegal and punishable. Basis the recommendation, the Government, on 02-11-2017, the Government formed the said committee.

- 9.7 RBI issued another Press Release dated 05-12-2017 reiterating the concerns expressed in earlier press releases. The Government of India, Ministry of Finance also issued a statement on 29-12-2017 cautioning the users, holders and traders of virtual currencies that they are not recognized as legal tender and that the investors should avoid participating in them.
- 9.8 While presenting Union Budget 2018, Late Shri. Arun Jaitleyji, the then Finance Minister, in his budget speech stated that "The government does not consider cryptocurrencies legal tender or coin and will take all measures to eliminate use of these crypto-assets in financing illegitimate activities or as part of the payment system".
- 9.9 The Central Board of Direct Taxes (CBDT), by an Office Memorandum, dated 05-Mar-2018, submitted to the Department of Economic Affairs, a draft scheme proposing a ban on cryptocurrencies. But the draft scheme advocated a step-by-step approach, as many persons had already invested in cryptocurrencies. The scheme also contained an advice to carry out legislative amendments before banning them.
- 9.10 The Inter-Ministerial Committee in its report dated 28-Feb-2019 made certain recommendations which included a complete ban on private cryptocurrencies.
- 9.11 On 22-Jul-2019, the Report of the Inter-Ministerial Committee, recommending a ban, along with the draft of the Bill "Banning of Crypto currency and Regulation of Official Digital Currency Bill 2019", was hosted in the website of the Department of Economic Affairs. The draft of the bill contained a proposal to ban the mining, generation, holding, selling, dealing in, issuing, transferring, disposing of or using crypto currency in the territory of India. At the same time, the bill contemplated (i) the creation of a digital rupee as a legal tender, by the central government in consultation with RBI and (ii) the recognition of any official foreign digital currency, as foreign currency in India

- 9.12 In Jan'2022, the Prime Minister of India at virtual Davos summit of the World Economic Forum said "today with change in global order, the challenges we face are also increasing. To fight these challenges, every country and every international organisation needs to take collective and synchronised action. Supply chain disruption, inflation and climate change are such examples. Another example is cryptocurrency. The kind of technology that is linked to it, steps taken by one country will be insufficient to face such challenges. We have to take one view on it."
- 9.13 In Union Budget 2022, the Finance Minister Ms. Nirmala Sitaraman, in her budget speech spoke about introducing Central Bank Digital Currency (CBDC), which will give a big boost to digital economy, stating that a "Digital currency" will also lead to a more efficient and cheaper currency management system and proposed to introduce Indian Digital Rupee, using blockchain and other technologies, to be issued by the Reserve Bank of India starting 2022-23. The Union Budget 2022 also introduced a scheme of taxation of virtual digital assets.
- 9.14 Perceptibly, the Indian Government, does not favour transactions in digital currency, as it does not allow, traceability and makes enforceability, dependent on the self-declaration of the user, which can create the mockery of the regulatory system. While, globally, most economies are finding grounds to arrive at a common mechanism, to treat and regulate digital currencies, the only probable solution, which regulators consider, is to bring into circulation, its own digital currency, which can be considered as parallel to private digital currencies and to bring in regulatory provisions that disincentivize the users to trade in private digital currencies. The statement made by the Hon'ble Finance Minister in Union Budget 2022, appears to be a step in this direction.

10. Draft bill to ban Crypto

- 10.1 The Indian Government was apparently clear in various of its communications to ban dealings in Cryptocurrency. On the recommendation of the Inter-Ministerial Committee, the Government, in the year 2019, had presented a draft of the “Banning of Cryptocurrency and Regulation of Official Digital Currency Bill, 2019”, to be tabled in the Parliament
- 10.2 However, there were apprehensions on use of the term ‘ban’ and recommendation was to consider regulating them and basis this recommendation, Mr. Pankaj Chaudhary, Minister of State in the Finance Ministry, stated that A bill on “Cryptocurrency and Regulation of Official Digital Currency Bill, 2021”, is under finalization and for consideration of the Cabinet. The bill is yet to be tabled in the Parliament.
- 10.3 The draft Bill seeks to provide the following:
- (i) Prohibit persons to mine, generate, hold, sell, deal in, issue, transfer, dispose of or use Cryptocurrency in the territory of India. However, the restriction will not apply to any person using the technology or processes underlying any Cryptocurrency for the purpose of experiment or research, including imparting of instructions to pupils.
 - (ii) The Central Government, in consultation with the Central Board of the Reserve Bank, may approve issuance of Digital Rupee, as legal tender, with effect a date to be notified
 - (iii) The Reserve Bank may by notification declare any official foreign digital currency to be recognised as foreign currency in India
 - (iv) No person shall directly or indirectly use Cryptocurrency in any manner, including, as (a) a medium of exchange; and/or; (b) a store of value; and/or; (c) a unit of account
 - (v) No person shall directly or indirectly use Cryptocurrency for activities including, (a) as a payment system, whether authorised under Section 4 of the Payments and Settlement Systems Act, 2007 (51 of 2017) or otherwise; (b) buy or sell or store Cryptocurrency; (c) provide Cryptocurrency related services to consumers or investors which includes registering, trading, settling, clearing or other services; (d) trade Cryptocurrency with Indian currency or any foreign currency; (e) issue Cryptocurrency related financial products; (f) as a basis of credit; (g) issue cryptocurrency as a means of raising funds; and/or (h) as a means for investment.
 - (vi) There are regressive penalties for violating the provisions of the enacted bill

10.4 It is apparent from the draft Bill that Indian Government is looking to completely ban private cryptocurrencies in India and it will recognize only the digital currency issued by the Government/ RBI. There may be mixed answers on the correctness or otherwise of the Government decision to completely ban. However, one thing is clear that while Government appreciates the technology behind but it does not desire to allow diminution in the value of its own currency or its economic control, consequent to acceptance of private virtual digital currencies.

11. Definition of virtual currency or assets in the global context

11.1 The regulators and Governments across the globe are perplexed on determining the appropriate manner of tax and to create a balance between promoting development and restricting its misuse. The below are some illustrations on how regulators and Governments across the globe, define and treat virtual currencies:

International Monetary Fund	Virtual Currencies are digital representations of value, issued by private developers and denominated in their own unit of account, which can be obtained, stored, accessed, and transacted electronically, that are useable for a variety of purposes.
Financial Action Task Force	A virtual asset is a digital representation of value that can be digitally traded, or transferred, and can be used for payment or investment purposes.
European Securities and Markets Authority	Crypto-assets is a type of private asset that depends primarily on cryptography and Distributed Ledger Technology (DLT) or similar technology as part of their perceived or inherent value.
Financial Conduct Authority, United Kingdom	Crypto-assets are a cryptographically secured digital representation of value or contractual rights that is powered by forms of DLT and can be stored, transferred or traded electronically.
IRS, Department of Treasury, USA	Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value
Virtual Financial Asset Act, 2018 - Malda	<p>“virtual financial asset” means any form of digital medium recordation that is used as a digital medium of exchange, unit of account, or store of value and that is not -</p> <ul style="list-style-type: none">(a) electronic money;(b) a financial instrument; or(c) a virtual token; <p>“virtual token” means a form of digital medium recordation whose utility, value or application is restricted solely to the acquisition of goods or services, either solely within the distributed ledger technology platform on or in relation to which it was issued or within a limited network of distributed ledger technology platforms.</p>

Canada Revenue Agency	Cryptocurrency is a digital representation of value that is not legal tender. It is a digital asset that works as a medium of exchange for goods and services between the parties who agree to use it.
Supervision of Financial Services Law - Israel	Financial asset includes virtual currency
Austria	Treats virtual currency as 'other intangible commodity'
Czech Republic	Treats virtual currency as 'commodity'
Germany	Virtual currencies are considered as 'financial instruments'.
Luxembourg	Parliament recognizes that crypto currencies are actual currencies
El Salvador	Bitcoin is accepted as legal tender or currency
Central African Republic	Bitcoin is accepted as legal tender or currency
Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations, 2002 - Canada	Virtual currency means (a) a digital representation of value that can be used for payment or investment purposes that is not a fiat currency and that can be readily exchanged for funds or for another virtual currency that can be readily exchanged for funds; or (b) a private key of a cryptographic system that enables a person or entity to have access to a digital representation of value referred to in paragraph (a).
European Union's Directive 2018/843 of 30 May 2018 (5th Anti-Money Laundering Directive)	'Virtual Currencies' means a digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency and does not possess a legal status of currency or money, but is accepted by natural or legal persons as a means of exchange and which can be transferred, stored and traded electronically
HM Revenue & Customs - United Kingdom	Crypto-assets (or 'cryptocurrency' as they are also known) are cryptographically secured digital representations of value or contractual rights that can be: <ul style="list-style-type: none"> • transferred • stored • traded electronically HMRC does not consider crypto-assets to be currency or money.

Washington
Uniform Money
Services Act

“Virtual currency” means a digital representation of value used as a medium of exchange, a unit of account, or a store of value, but does not have legal tender status as recognized by the United States government. "Virtual currency" does not include the software or protocols governing the transfer of the digital representation of value or other uses of virtual distributed ledger systems to verify ownership or authenticity in a digital capacity when the virtual currency is not used as a medium of exchange.

- 11.2 Perusal of the above would evidence that there is unanimity of opinion among all the regulators and the governments of various countries that though virtual currencies have not acquired the status of a legal tender, they nevertheless constitute digital representations of value and that they are capable of functioning as (i) a medium of exchange and/or (ii) a unit of account and/or (iii) a store of value.
- 11.3 More and more countries are in the process of issuing Government backed digital currency, which will have the characteristic of money but private virtual currencies, would be categories basis appropriate jurisdictional Governmental policy, in a manner, which promotes development, provides revenue and restricting them from being used for not permitted activities.

12. Meaning of virtual digital assets from Indian context

- 12.1 The technology on which virtual currency are built and operated, bring complexity in determining or as the context requires, whether they are to be regarded, as:
- (i) Currency?
 - (ii) Form of money?
 - (iii) Financial instrument?
 - (iv) Security?
 - (v) Actionable claim?
 - (vi) Property?
 - (vii) Goods?
 - (viii) Services?
- 12.2 Digital assets are not defined under any Indian law other than in Section 2(47A) of the Indian Income Tax Act, 1961, which seeks to tax the income from transactions in virtual digital assets. The term is defined as follows:
- (47A) “virtual digital asset” means
- (a) any information or code or number or token (not being Indian currency or foreign currency), generated through cryptographic means or otherwise, by whatever name called, providing a digital representation of value exchanged with or without consideration, with the promise or representation of having inherent value, or functions as a store of value or a unit of account including its use in any financial transaction or investment, but not limited to investment scheme; and 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:
- 12.3 The above definition is identically similar to the meaning of “Cryptocurrency” in the draft bill for Cryptocurrency and Regulation of Official Digital Currency Bill, 2021, which is sought to be defined as under:
- “Cryptocurrency” by whatever name called, means any information or code or number or token not being part of any Official Digital Currency, generated through cryptographic means or otherwise, providing a digital representation of value which is exchanged with or without consideration, with the promise or representation of having inherent value in any business

activity which may involve risk of loss or an expectation of profits or income, or functions as a store of value or a unit of account and includes its use in any financial transaction or investment, but not limited to, investment schemes

12.4 Perusal of the definition of virtual digital assets evidences that the definition gives us as to ‘what it is, how it is generated or derived, what it provides to have, how it can be obtained, what it has, how it functions and what can be done with it’.

12.5 Comparison of this exhaustive definitions with the definitions by various regulators and authorities outside India, would evidence that the definition provided by Indian regulators, appears to give an exhaustive meaning, giving a fair and reasonable representation of its nature and characteristics. In order to comprehend its scope and meaning, it would be important for us to analyze the same. The definition of ‘virtual digital assets’ is hence broken down, to enable us decipher, in the manner provided in the table below:

Meaning of digital assets	Explanation of the meaning
<ul style="list-style-type: none"> Any information or code or number or token 	<ul style="list-style-type: none"> The terms ‘information, code, number or token’, are very wide and would represents the entire gamut of crypto currencies. Crypto or virtual digital assets are nothing but, either an information or a code or a number or a token, which is assigned to an owner, as having an inherent defined units
<ul style="list-style-type: none"> Not being Indian currency or foreign currency, 	<ul style="list-style-type: none"> A Currency is a representation of value issued by a central authority and in the case of India, by RBI. Definition of currency and foreign currency is provided in the ensuing paragraph’s and digital assets are not regarded as either Indian or Foreign Currency The digital currency, proposed to be issued by RBI, will be notified as Indian Currency and therefore it would not be falling within the meaning of virtual digital assets, as provided herein
<ul style="list-style-type: none"> Generated through cryptographic means or otherwise, by whatever name called, 	<ul style="list-style-type: none"> Crypto currencies such as Bitcoin, Ethereum or any other virtual currencies, are secured by cryptography. Accordingly, it would have been appropriate for legislator to have used the term ‘secured through cryptographic means’ rather than to have stated as ‘generated through’. However, taking it in the crude form, the code or token or information or number, is generated using cryptography and all virtual digital currencies, generated as such, would therefore satisfy this condition

Meaning of digital assets	Explanation of the meaning
<ul style="list-style-type: none"> • Providing a digital representation of value 	<ul style="list-style-type: none"> • Similar to money or currency, virtual digital assets, represent a value of its worth, as illustrated below: 1 bitcoin = 10 Decibit = 100 Centibit = 1000 Millibit
<ul style="list-style-type: none"> • Exchanged with or without consideration, 	<ul style="list-style-type: none"> • It can be obtained either by consideration which is exchanged or obtained without any consideration. The stated consideration may be adequate or inadequate and the nature is such, that it can be exchanged with another unit of the same class i.e. I exchange my 1 Rupee with your 1 Rupee, or can be exchanged for any other currency, goods, services, property or the like
<ul style="list-style-type: none"> • With the promise or representation of having inherent value, 	<ul style="list-style-type: none"> • The inherent value is the importance or usefulness placed on the virtual digital assets. Such assets can be used as investment purposes or for exchange of other goods or services or property or such other utility it may demonstrate to have. On the corollary, not having an inherent value would mean not a digital asset • The term inherent value need not mean that it be backed by any underlying currency or asset but to be and have or showcase, the usefulness it has, in its exchange for other goods or services or property or the like
<ul style="list-style-type: none"> • Or functions as a store of value 	<ul style="list-style-type: none"> • The term 'store of value' would represents a purchasing power of an item that can be saved, exchanged or retrieved in future.
<ul style="list-style-type: none"> • Or a unit of account 	<ul style="list-style-type: none"> • Similar to money or currency, virtual digital assets, represent a value, which can be denominated against other currencies or goods or units, and has these characteristics: (1) Divisible (Rupee dividend into Paise or Anna); (2) Fungible (1 Rupee note with me or you, is same) (3) Measurable (10 units of 1 Rupee) 1 bitcoin = INR 24,00,000 = USD 30,500 = 500 gram gold
<ul style="list-style-type: none"> • Including its use in any financial transaction or investment, but not limited to investment scheme; 	<ul style="list-style-type: none"> • May be usable similar to equity investment, loan, purchase of shares or security, chit fund, deposit, etc., which have financial or investment characteristic
<ul style="list-style-type: none"> • And can be transferred, stored or traded electronically 	<ul style="list-style-type: none"> • A substantive character for a virtual digital asset, should be the ability to transfer from one person to another, to be held in store (such as in a wallet or with digital asset exchanges) or be traded digitally or electronically from one person to another.

12.6 There are digital assets, whose underlying value is backed or pegged, or tied, to that of another currency, commodity or financial instrument, to ensure that their value do not fluctuate and hence are called as ‘stablecoin’ such as Tether, USD Coin, Binance USD, etc. There are other digital assets, which does not have any underlying value or asset nor are they backed by any Government or statutory authority such as Bitcoin, Ethereum, Cardano, Bitcoin Cash, Stellar, etc., whose value fluctuates, basis their demand or supply. In both these cases, they are digital assets. This is for the reason that they are all secured or generated using cryptography, which have digital representation of value, satisfying the test of having inherent value or having a store of value with a unit of account which can be transferred, stored or traded electronically and which are not considered as Indian or Foreign Currency.

Non-Fungible Token (NFT)

12.7 Definition of virtual digital assets include non-fungible tokens. The term ‘Fungible’ means something which is exchangeable for something of the same kind. However, non-fungible means something which is unique and not common. The following examples will illustrate difference the between a fungible and non-fungible item:

Examples of Fungible Goods	Examples of Non-Fungible Goods
Hyundai Creta SX Car	Car with number plate KA 05 NA 6781
Rupee of denomination 100/-	100 Rupee Note with SI No. 89A 123456
Plain White T-Shirts of Size M	T-Shirt worn by Hrithik Roshan in Movie Dhoom
Paintings of Mona Lisa	Original Painting of Mona Lisa at Louvre in Paris
100 Gram Gold Bar	Kohinoor Diamond

12.8 The above are examples in a real world scenario. In digital space, one could tokenize unique things i.e. digital art, digital game, domain name, collectibles, music videos, movies, digital real estate, etc., to a particular owner, which is owned only by the assigned owner and no-body else. The particular digital asset, is assigned a unique token, earmarked to owner and hence the name non-fungible token.

12.9 Using blockchain, an identified digital asset, through consensus mechanism, is registered in the name of the owner, on a distributed ledger, using smart contracts. The system allows transfer of the ownership rights, details of

which are recorded on blocks and transactions of which are executed for consideration in crypto currencies or FIAT currencies. Anything, which is unique in a digital space, can be created into an NFT and similar to crypto currencies, NFT's market cap, is growing at a very rapid pace. It is estimated to be USD 3 Billion at an annual compounded rate of 35%.

- 12.10 The definition of virtual digital asset, includes NFT's. In a popular example, Amitabh Bachchan, created NFT of Madhushala, the poetry work of his father Mr. Harivansh Rai Bachchan and sold the same for USD 756,000 or for about INR 56 Million in the NFT marketplace. In another example, Jack Dorsey, the founder of Twitter, his first tweet, was created into an NFT and was sold to Crypto entrepreneur Sina Estavi, for USD 2.9 Million in 2021. However, in April 2022, Sina Estavi, set to sell this NFT, through auction but could get only USD 280 as the highest bid, which evidences, how subjective the valuations for such NFT's are.
- 12.11 In the digital world, NFT's are digital rights to properties or assets in various forms and they are freely transferable. Similar to Amazon and Flipkart, NFT marketplaces such as Rarible, OpenSea, SupreRare, Foundation, Binance, etc., enable creation and sale of unique digital assets. Trade in such digital assets are often undertaken through consideration exchanged in digital currencies such as bitcoin, Ethereum, Binance, etc. Given that the digital rights are created in favour of an owner, NFT's are therefore regarded as virtual digital assets.
- 12.12 The digital market space is ever evolving and there is every possibility that technological developments in this space, may create a digital asset, which may not fall within the current definition of virtual digital assets. Accordingly, under sub-clause (iii) of Section 2(47A), Government may notify any other digital assets, as a virtual digital asset, to expand or include them, in the assigned meaning.

13. Implications under Direct Taxes

- 13.1 The transactions in virtual digital currencies have been rampant in the past many years but with no special provisions to determine the tax and with the ambiguity whether transactions in virtual digital assets are legal, assessee's did not offer income on such transactions to tax. In the Union Budget Speech for the year 2022-23, the Finance Minister 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.'
- 13.2 Accordingly, the Finance Act, 2022 introduced a new specific tax regime for transactions in virtual digital assets (VDA). Under the Scheme for VDA, any income from transfer of VDA shall be taxed @ 30% [Plus applicable surcharge and cess] w.e.f. FY 2022-23, by introduction of the following provisions in the Income Tax Act, 1962 (Act):

Provision introduced	Particulars
Section 115BBH: Method of computation and the tax rate for the income arising from transfer of VDA	Provides for the method of computation of income arising on the transfer of VDA, the rate of tax (i.e. 30%) and other matters
Section 2(47A): Meaning of VDA	Defines the term VDA in elaborate manner
Addition of VDA to the definition of 'property' for taxation of deemed income under Section 56(2)(x)	Provides for taxation of Gift of VDA in the hands of the recipient
Section 194S: TDS on payment of consideration on the transfer of VDA	In order to capture transaction details, provides for TDS on payment made in relation to transfer of VDA @ 1% of such consideration above a monetary threshold

Section 115BBH: Method of computation and applicable tax rate

- 13.3 The use of the non obstante clause in Section 115BH means that the income from transfer of VDA will be taxed separately at a flat rate of 30%* irrespective of any other provisions in the Act. The taxation under section 115BBH of the Act shall be as under:

- (a) There should be a transfer of any VDA, whether held as capital asset or not;
- (b) The cost of acquisition, if any, only shall be allowed as deduction. No other deduction in respect of any expenditure or allowance is allowed;
- (c) No set-off of any loss under any provision of the Act shall be allowed in computing such income;
- (d) Tax on income from transfer of such VDA shall be calculated at the rate of 30%*;
- (e) Further, any loss from the transfer of a VDA shall not be allowed to be set-off against income computed under any provision of this Act; and such loss shall not be allowed to be carried forward to succeeding assessment years

Transfer: Section 2(47) of the Act

13.4 Section 115BBH(3) states that the word 'transfer' as defined Section 2(47) shall apply to VDA, whether capital asset or not. Section 2(47) defines the term 'transfer' as under:

"transfer", in relation to a capital asset, includes, –

- (i) *the sale, exchange or relinquishment of the asset; or*
- (ii) *the extinguishment of any rights therein; or*
- (iii) *the compulsory acquisition thereof under any law; or*
- (iv) *in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment; or*
- (iva) *the maturity or redemption of a zero coupon bond; or*
- (v) *any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882; or*
- (vi) *any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property*

Explanation 1. – For the purposes of sub-clauses (v) and (vi), "immovable property" shall have the same meaning as in clause (d) of section 269UA.

Explanation 2. – For the removal of doubts, it is hereby clarified that "transfer" includes and shall be deemed to have always included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner

whatsoever, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights has been characterised as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India;

13.5 Term 'transfer' has been defined in an inclusive manner, which means that the term shall be deemed to include all transactions mentioned therein besides what is otherwise understood as transfer in common parlance. The following transactions are specifically included:

- (a) Sale;
- (b) Exchange;
- (c) Relinquishment;
- (d) Extinguishment of any rights therein;
- (e) Compulsory acquisition; and
- (f) Conversion of investment/capital asset into stock-in-trade

13.6 However, Section 47 of the Act, lists the transactions that are not to be regarded as 'transfer' and hence, any income or gains arising from the such transactions shall not be chargeable to tax under Section 115BBH of the Act, viz., *inter alia*:

- (a) distribution on the total or partial partition of a Hindu undivided family;
- (b) transfer under a gift or will or an irrevocable trust;
- (c) transfer by a company to its subsidiary company or vice versa (subject to conditions);
- (d) transfers under restructuring schemes (subject to conditions);
- (e) transfers on conversion of firm/sole proprietor to a company or company a LLP (subject to conditions)

In addition, in terms of Section 46 of the Act, distribution of assets by companies in liquidation to its shareholders, is not regarded as transfer by the company.

13.7 In terms of Section 47(iii) of the Act, any gift of a capital asset is not regarded as transfer. Accordingly, the gift of VDA, would not be regarded as a transfer, and would be exempt from tax in the hands of donor.

Taxability of VDA acquired as a capital asset and converted into stock in trade

- 13.8 Where a VDA is acquired as investment/capital assets, but subsequently converted into stock in trade of a business carried on by him, it shall be deemed that the VDA is transferred during the previous year in which such conversion took place. Further, the fair market value (FMV) of the VDA, as on the date of conversion or treatment is deemed to be the full value consideration received or accruing as a result of transfer of the VDA. However, the liability to pay tax arises in the previous year in which such stock-in-trade is sold or otherwise transferred [Section 45(2)].
- 13.9 Similarly, if VDAs, held as inventory of a business, are converted into capital assets, its FMV, as on the date of conversion shall be taxable as business income under Section 28(iva) of the Act. The FMV of the inventory so converted shall be the price it would ordinarily fetch on sale in open market on the date of conversion.

Taxability of VDAs transferred not at its FMV

- 13.10 Section 115BBH neither provides the method of computation of FMV nor gives the power to CBDT to prescribe it, unlike as provided for, in Section 50C (Special provision for full value of consideration in certain cases) and Section 50CA (Special provision for full value of consideration for transfer of share other than quoted share).
- 13.11 The Hon'ble Supreme Court in the case of **CIT Vs. Gillanders Arbuthnot & Co** [1973 (87) ITR (407)] held that in the case of sale for a price, there is no question for any market value unlike in the case of an exchange. Therefore, in case of sales, all that one has to see is what is the consideration bargained for. Hence, the consideration received for the transfer is to be considered for computation of income from VDA.

Transfer of VDA by way of exchange with another capital asset or in kind

- 13.12 Currently, there are no rules for computation of FMV in case of transfer of VDA. In terms of Section 50D, FMV is deemed to be full value of consideration in certain cases, provided that where the consideration received or accruing as a result of the transfer of a capital asset by an assessee is not ascertainable or cannot be determined, then for the purpose of computing income chargeable to tax as capital gains, the FMV of the said asset on the date of transfer shall be deemed to be the full value of the consideration received or accruing as a result of such transfer.'

13.13 Accordingly, in case of transfer of VDA by way for exchange with capital asset, the FMV of the asset can be deemed to be the full value of consideration. There may be practical difficulties in determining the FMV of VDA's due to high fluctuation in its value and moreover, exchange platforms may have different prices for same virtual currency, at a given point of time.

Cost of acquisition of VDA

13.14 While computing the capital gains or business income from transfer of VDA, except for the cost of acquisition, no other deduction or exemption is allowed. Hence, the following items shall be ignored by computing income from transfer of VDA:

- (a) Expenditure incurred in connection with the transfer of VDA;
- (b) Cost of improvement relating to VDA;
- (c) Exemption under Section 54F of the Act;
- (d) Depreciation; and
- (e) Other expenses.

Cost of acquisition for multiple buy & sale transactions (same type)

13.15 Section 115BBH does not provide any guidance on how buy and sale transactions should be correlated in case of a person regularly buying and selling a VDA. In this regard, there are two possible views:

- (i) Follow FIFO method: As per Circular No. 768 dated June 24, 1998, issued by CBDT, FIFO method should be used to determine the period of holding of securities held in demat form (akin to the digital form VDA are held).
- (ii) Follow weighted average method: in the absence of specific guidance in Section 115BBH or similar clarification from the CBDT for VDAs.

13.16 Apparently, the net income or loss from transfer of VDAs would eventually be same in either case, while, the selection of the method makes a difference as losses from transfer of one VDA cannot be set-off against income from transfer of another VDA.

What would be the cost of acquisition in the case of mining?

13.17 To mine a cryptocurrency, a person invests in computers and mining machinery and also, incurs huge electricity charges. Whether such capital expenditure and electricity charges can be considered as cost of acquisition of a mined cryptocurrency. In other words, can the cost of creating a capital asset be considered as its cost of acquisition?

13.18 The Income-tax Act is silent on the method of computation of cost of acquisition of a VDA generated during the mining process. However, to a question on whether infrastructure costs incurred in mining cryptocurrencies are to be treated as cost of acquisitions and therefore permissible deduction, the Ministry of Finance on 21 March 2022, answered in the Parliament that *“infrastructure costs incurred in mining of VDA, will not be treated as cost of acquisition as the same will be in the nature of capital expenditure which is not allowable as deduction as per the provisions of the Act”*

13.19 Hence, based on the above, the authorities would allege that the cost of acquisition, for mining of cryptocurrencies, is NIL. However, a different view does exist. The word ‘acquisition’ is of wider amplitude than the word ‘purchase’. A purchase is one of the modes of acquisition and a property can be acquired even otherwise than a purchase. The Gujarat High Court in the case of *CIT v. Mohanbhai Pamabhai [(1973) 91 ITR 393]*, affirmed by the SC *[(1987) 165 ITR 166]*, held as under:

“The word "acquisition" is the noun from the verb "acquired" and the meaning of the word "acquired" would, therefore, throw light on the true connotation of the word "acquisition". Black's Law Dictionary gives the following meaning of the word "acquire": "To gain by any means, usually by one's own exertions; to get as one's own; to obtain by search, endeavor, practice, or purchase; receive or gain in whatever manner; come to have. The word "acquire", accordingly to its plain natural meaning, is a word of very wide import. It is not confined to obtaining of a thing from the third party. When an assessee gains a thing by his own exertions or comes to own it or have it by any recognized mode which would doubtless include the mode of creation, he can be said to have acquired the thing. There are various modes of acquisition by which a thing may be acquired, by an assessee and creation is one of them. When an assessee creates a painting, sculpture, or a building, he gains it, he comes to have it or to own it. He acquires the painting sculpture or building by creating it. When a capital asset is created by an assessee, it becomes his property, he come to own it and, therefore, he acquires it the moment it is created. Creation or production of a capital asset is not foreign to the concept of acquisition and even where a capital asset is self-created asset of the assessee, it would be covered by clause (ii) of section 48 and if any cost has been incurred by the assessee in creating or producing it, it would represent the cost of acquisition of such capital asset”.

13.20 Relying upon the aforesaid judgement, it can be said that when a cryptocurrency is created, it is deemed to be acquired. Therefore, all expenditure incurred during the creation process should be considered as the cost of acquisition unless Section 55 explicitly disallows such cost of creation. Hence, possible litigation may arise on this.

No indexation benefits irrespective of holding period

- 13.21 Indexation accounts for the inflation during the holding period and accordingly adjusts the acquisition price upwards, reducing the tax liability of the investors. In case of a loss, a holder of an asset can even claim a loss if the inflation rate is higher than the return on investment. Such indexation benefits are available to asset classes like gold, property, debt funds, depending on the holding period.
- 13.22 Section 115BBH(2) starts with a non obstante clause, as '*Notwithstanding anything contained in any other provision of this Act*'. Hence, it will override all other provisions of the Act including the second proviso to Section 48 which provides for indexation of cost of acquisition. Further, Section 115BBH does not provide for a different rate of taxation based on the period of holding of the VDA. Hence, the indexation of cost of acquisition of VDA would not be allowed, irrespective of the holding period

Classification of Income from transfer of VDA: Heads of Income

- 13.23 The Income Tax Act makes a distinction between 'Capital Asset' and 'Trading Asset'. In terms of Section 2(14) of the Act, gains from transfer of capital assets are taxable under the head capital gains and gains from trading assets are taxable as business income under Section 28 of the Act. Determination of characters of VDA, i.e., whether the same is in the nature of a capital asset or stock-in-trade, is to be determined based on facts. Based on the objects of business, accounting in the books of taxpayer, magnitude of transaction, etc., the nature of VDA needs to be determined and accordingly taxed under appropriate head.
- 13.24 Generally, the income of traders of crypto currency would be taxable under the head Profit & Gains of Business or Profession and income of investors would be taxable under the head Capital Gains.
- 13.25 Though the rate of tax on VDA under either heads of income is same, the classification is essential for computation of interest under Section 234C of the Act. If a shortfall in payment of advance tax happens on account of underestimating or failure to estimate the accrual of capital gains, then such shortfall is ignored while computing interest under Section 234C of the Act.

Benefit of maximum exemption limit

13.26 Where an income is subject to tax at a special rate specified in Chapter XII (Determination of tax in certain special cases), the maximum exemption limit may not be allowed from such special income unless specifically allowed. For example, Section 111A, Section 112 and Section 112A of the Act, allows a resident individual and HUF to claim the maximum exemption limit from the income taxable under these provisions. Hence, the income computed under Section 115BBH shall be taxable at a flat rate of 30% without giving the benefit of maximum exemption limit.

Rebate under Section 87A of the Act

13.27 The rebate under Section 87A of the Act is allowed to any resident individual unless it is expressly prohibited. Section 115BBH does not prohibit such rebate, and it is neither a deduction nor allowance, and hence should be allowed to a resident individual.

Income of a non-resident from transfer of VDAs to a resident in India

13.28 In terms of Section 5(2), a non-resident is chargeable to tax in India, in respect of income which is:

- Received or deemed to be received in India; and
- Income which accrues or arises or is deemed to accrue or arise in India

13.29 Section 9(1)(1) of the Act provides that any income *inter-alia* from the transfer of capital asset in India would be deemed to accrue or arise in India and hence taxable in India. Hence, to determine whether the income arising to a non-resident on transfer of VDA, it would be important to identify the situs of the VDA. The Act does not provide any guidance on identification of situs of VDAs. A VDA is a capital asset akin to an intangible asset. Hence, reference may be drawn from judicial precedents on determination of situs of intangibles.

13.30 In the case of **CUB Pty Ltd Vs. UOI & Ors (WP (C) 6902/2008)**, the Delhi High Court, in the context of identification of situs of intangible assets, held that the situs of the owner of the VDA would be the situs of the VDA. Accordingly, the income of the non-resident from transfer of VDA may generally not be taxable in India u/s 115BBH. However, since the VDA could differ in characteristics, the situs needs to be determined by considering all relevant factors.

13.31 The taxation of a non-resident is subject to the beneficial provisions of the applicable Double Tax Avoidance Agreement.

Treatment of expenditure or allowance and losses

13.32 Section 115BBH(2) having non-obstante clause, contains the following two clauses:

- (a) Clause (a) provides that no expenditure or allowance (other than cost of acquisition, if any) shall be allowed while computing income under Section 115BBH. Further, no set-off of any loss shall be allowed to the assessee while computing such income.
- (b) Clause (b) provides that no set-off of loss from transfer of VDA computed under 115BBH(1)(a) shall be allowed against income computed under any provision of this Act and further, such loss shall not be allowed to be carried forward to the succeeding assessment years.

13.33 Both the above clauses attempt to ring fence the losses arising from transfer of VDA. It neither allows any loss to set-off against income from VDA nor allows loss from VDA to set off against income computed under any other provision of the Act. In other words, any loss arising from VDA would be a dead loss, and it will not be allowed to be adjusted even against income arising from transfer of another VDA (whether of the same category or not).

Deduction under Chapter VI-A is available against the income from VDA

13.34 Section 115BBH provides that no deduction or allowance would be available. Hence, a view is that no deduction shall be allowed under Chapter VI-A, from the income computed under Section 115BBH of the Act.

Treatment of losses incurred from VDA's on or before the AY 2022-23

13.35 Section 115BBH(2) prohibits carrying forward and setting-off of losses from VDAs w.e.f. AY 2023-24. The assessee should have a right to carry forward and set-off the losses incurred on or before the AY 2022-23. However, such losses shall not be allowed to set-off against the income taxable under Section 115BBH of the Act. Similar issue was dealt by Hon'ble Supreme Court in the case of *CIT Vs. Shah Sadiq & Sons [(1987) 31 Taxman 498]*, wherein it was held that a right accrued and become vested continued to be capable of being enforced notwithstanding the repeal of the statute under which the right accrued, unless the repealing statute took away this right specifically.

Taxability of income generated from lending of VDAs

13.36 Section 115BBH, specified only covers taxability in the case of transfer of VDA. Lending of VDA cannot be considered as a transfer since the title to the asset still remains with the lender.

13.37 The income generated through lending is generally credited in the form of same VDA that is lent. The income earned through such lending would be taxed as 'Income from other sources' or 'Profits & Gains from Business or Profession' as the facts of the case may be.

Taxability in hands of recipient u/s. 56(2)(x) of the Act

13.38 Section 56(2)(x) applies when a person receives any 'benefit' (in the form of money, immovable property or moveable property) whose value exceeds INR 50,000/-. The Finance Act, 2022 amended the meaning of property [Explanation (d) to Section 56(2)(vii) of the Act] to include 'Virtual Digital Assets'. Thus, where a person receives a VDA without consideration (gift) or for inadequate consideration and the value of such benefit exceeds INR 50,000/- it shall be taxable in the hands of the recipient under section 56(2)(x) as income from other sources.

13.39 It is to be noted that the property/VDA must constitute capital assets in the hands of the recipients to be taxable under the section. Further, receipt of VDA by employees as part of remuneration would be taxable as perquisite in the hands of employee under section 17(2)(iii). However, receipt of VDA by employees as gift shall not be taxable if the aggregate value of gifts received does not exceed Rs. 5,000/-.

Exemption from taxability

13.40 No deemed income shall arise under this provision, if the VDAs are received in the circumstances or occasion specified in the proviso to Section 56(2)(x) of the Act such as in the case where VDA is received from relatives on occasion of marriage of the individual or under a will or by way of inheritance.

Taxability under Section 28(iv) of the Act

13.41 Section 28(iv) states that the value of any benefit or perquisite, whether convertible into money or not, arising from business or exercise of a profession is chargeable to tax as business income. Where any person carries on any business or provides services, for which he receives or accrues consideration in the form of tokens, the market value of such token shall be taxable u/s. 28(iv) of the Act in the hands of the recipient.

13.42 If the income is taxable u/s. 56(2)(x) of the Act, the market value of the property is determined as per Rule 11UA of the Rules. However, if the income is taxable u/s. 28(iv) of the Act, the CBDT is not empowered to prescribe any rule to determine the market value of the benefit or perquisite arising from a business profession.

Taxability of credit card points and other digital reward assets received

13.43 VDA has been defined to include certain digital assets satisfying certain conditions including inter alia generated by 'cryptographic means or otherwise'. The words 'or otherwise', in law, when used as a general phrase following an enumeration of particulars, are commonly interpreted in a restricted sense, as referring to such other matters as are similar to the cases before mentioned. Hence, unless such digital assets are generated by cryptographic or other similar means, they should not be taxable as gift under Section 56(2)(x) or Section 28(iv), as the facts of the case may be.

Receipts of VDA's on mining

13.44 As per Section 115BBH, income from VDA shall be taxable only if it arises on the transfer of VDA. Section 2(47) of the Act defines 'transfer' (supra). In case of mining activities of VDA, which involves the process of verification of transactions of virtual currencies and adding to the block chain based ledger, there is no transfer and hence such activities may not be taxable. India like many other countries has followed the disposal event for taxation. Therefore, no income should arise from mining of cryptocurrency as the taxable event of 'transfer' is not triggered.

13.45 Further, on the receipt of cryptocurrency by way of a mining reward, Section 56(2)(x) shall not apply, as the same is not received from 'a person', which is pre-requisite for taxation under the provision.

Applicable tax rates

13.46 The value of the benefit arising from Section 56(2)(x) and Section 28(iv) shall be taxed at the rate applicable to the assessee. Such income shall not be taxed at the rate of 30% under Section 115BBH because it does not arise on account of transfer of VDA. However, when the recipient furthers transfers such assets, the resultant gains shall be taxable under Section 115BBH.

Cost of acquisition of VDAs received as gift

- 13.47 Where the VDA is received as gift, the cost of acquisition would depend on whether it is a capital asset or trading asset in the hands of the recipient. Where the VDA is received as a capital asset, the cost for which the previous owner acquired it shall be treated as the cost of acquisition. However, if the value of the VDA is charged to tax in the hands of the recipient under Section 56(2)(x) at the time of receipt thereof, then such value shall be treated as cost of acquisition (Section 49).
- 13.48 Where the gift of VDA is received as stock-in-trade, the cost of VDA in the hands of the recipient shall be determined as per Section 145A read with ICDS-II (Valuation of inventories)

Deduction of tax at source ('TDS') under Section 194S of the Act

- 13.49 The Finance Act, 2022 has inserted a new Section 194S for deduction of tax at source from payment of consideration for the transfer of VDA. The said section is applicable from 01 July 2022. As per the provisions of Section 194S, any person (resident or non-resident) responsible for paying any sum by way of consideration, to a resident, for the transfer of a VDA is required to deduct TDS.
- 13.50 The tax is required to be deducted at the rate of 1% of the consideration. The rate shall not be further increased with surcharge and health and education cess.
- 13.51 The tax required to be withheld under section 194S of the Act shall be on the 'net' consideration after excluding GST/charges levied by the deductor for rendering service.

TDS Implications on transfer of VDA on or through an Exchange (and Broker)

- 13.52 The term '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.
- 13.53 The term '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.

VDA owned by a person other than the Exchange

- 13.54 Tax shall be deducted by the Exchange which is crediting or making payment to the seller (or to the broker where broker owns the VDA)
- 13.55 In a case where the credit/payment between Exchange and the seller is through a broker (and the broker is not seller), the responsibility to withhold tax, shall be on both i.e. the Exchange and the broker. However, if there is a written agreement between the Exchange and the broker that broker shall be deducting tax on such credit/payment, then broker alone may deduct the tax. The Exchange would be required to furnish a quarterly statement (in Form no 26QF) for all such transactions of the quarter on or before the prescribed due date.

VDA owned by Exchange:

- 13.56 While the primary responsibility to withhold tax, remains with the buyer or his broker, as an alternative, the Exchange may enter into a written agreement with the buyer or his broker that in regard to all such transactions the Exchange would be paying the tax on or before the due date for that quarter. In this regard, the Exchange would be required to furnish a quarterly statement (in Form No. 26QF) for all such transactions of the quarter on or before the prescribed due date.

Time of deduction

- 13.57 The tax shall be deducted at the time of payment by any mode or at the time of credit of such sum to the account of the resident, whichever is earlier. Where a person does intra-day trading in cryptocurrencies, the tax shall be deducted every time a transaction is squared off.
- 13.58 Where any sum referred above is credited to any account, whether called 'Suspense Account' or by any other name, in the books of account of the person liable to pay such sum, such credit of the sum shall be deemed to be the credit of such sum to the account of the payee and the provisions of this section shall apply accordingly.

Transactions through payment gateways

- 13.59 Payment gateway will not be required to deduct tax, if the tax has been deducted by the buyer person required to make deduction under section 194S of the Act. To facilitate proper implementation, payment gateways may take an undertaking from buyer regarding deduction of tax.

Consideration in kind

- 13.60 As per proviso to Section 194S(1), where the consideration for transfer of VDA is wholly in kind or in exchange of another VDA (i.e. where there is no part in cash); or partly in cash and partly in kind but the part in cash is not sufficient to meet the liability of TDS in respect of the whole transfer, then the person responsible for paying the consideration shall before releasing the consideration, ensure that the tax required to be deducted has been paid in respect of such consideration for the transfer of VDA i.e. the buyer will release the consideration in kind after seller provides proof of payment of such tax (e.g. Challan details etc.).
- 13.61 It may be noted that in case of exchange of VDAs, the transfer of VDA shall happen both in the case of the payer and the payee. Thus, in such cases, both payer and payee may be liable to deduct tax under Section 194S. This would then be required to be reported in TDS statement (Form 26Q) along with challan number. For specified persons, Form No. 26QE has been introduced.
- 13.62 However, if the transaction is through an Exchange, as an alternative, tax may be deducted by the Exchange, based on written contractual agreement with the buyers/sellers.
- 13.63 If such an alternative mechanism is exercised, the Exchange would be required to deduct tax for other legs of the transactions and pay to the Government and report in Form 26Q (on both legs of the transaction).

Conversion of TDS deducted in kind

- 13.64 At the time of transaction, the Exchange will deduct TDS in the pair being traded. The trail of transactions evidencing deduction of 1% of consideration for every VDA to VDA trade shall be maintained by the Exchange.
- 13.65 The Exchanges shall immediately execute a market order for converting this tax deducted in kind to one of the primary VDAs (BT, ETH, USDT, USDC) which can be easily converted into INR. Time stamps of timing of orders to be maintained to ensure such conversion of VDAs withheld to be done on immediate basis by the Exchange. If the taxes are withheld in primary VDAs, this step would be ignored.
- 13.66 All the tax deducted under section 194S of the Act in the form of primary VDAs {or converted into primary VDA under step (ii)} will be accumulated for the day. Time limit will be from 00:00 hours to 23:59 hours. VDA accumulation by the Exchange shall be verifiable from the trail of orders for VDA to VDA trades executed during the day.

- 13.67 The accumulated balance of primary VDAs at 00.00 hours will be converted into INR based on the market rate existing at that time. In order to bring in consistency and to avoid discretion, the Exchanges are required to place market order at 00:00 hours for the tax withheld {or converted under step (ii)} in form of primary VDAs for conversion into INR. These 'sell' market orders shall be executed based on the open 'buy' orders in the market. Price and quantity data for every matched trade shall be maintained by the Exchange and shall be available for verification. It shall be verifiable from the system coding that the conversion into INR happened at the first available buy order based on the prevailing buy order book of the respective Exchange at the time of conversion. As a practice, the respective Exchange liquidating the VDA shall be prohibited to be a buyer for these VDAs.
- 13.68 Customer will be issued a contract note over email which will include the amount of tax withheld in kind under section 194S and the amount of INR realized from such tax withheld.
- 13.69 The tax withheld in kind u/s. 194S of the Act and converted into INR by following the stated procedure shall be deposited in Government Account as per the time line and process given in the Income Tax Rules, 1962. There would not be any further TDS for converting the tax withheld in kind in the form of VDA into INR or from one VDA to another VDA and then into INR.

Rate of TDS

- 13.70 If the deductee does not furnish PAN to the deductor, the tax shall be deducted at the rate of 20% as per provisions of Section 206AA of the Act.

Specified Payer relaxation of Section 203A and Section 206AB

- 13.71 The provisions of section 203A (dealing with obtaining and use of tax deduction account number) and Section 206AB (providing for higher rate of TDS in the case of non-filers of return) shall not apply to specified person being:
- (a) An individual or a HUF, whose total sales, gross receipts or turnover does not exceed INR 10 Million, in case of business or INR 5 Million, in case of profession, during the FY immediately preceding the FY in which such VDA is transferred;
 - (b) An individual or a HUF who does not have any income under the head Profits and Gains from Business or Profession.

Exemption from TDS

13.72 No tax shall be deducted under the provision

- (a) if the consideration is payable by any person (other than specified person) and its aggregate value does not exceed INR 10,000/- during the financial year;
- (b) if the consideration is payable by the specified person (supra) and its aggregate value does not exceed INR 50,000/- during the financial year

Any amount of sum which has been credited or paid before 1st July 2022 would not be subjected to tax deduction under section 194S of the Act.

Overriding effect of provision: Multiple TDS provisions applicable to the payer

13.73 Where a transaction is subject to TDS u/s. 194-O (Payment of certain sums by e-commerce operator to e-commerce participant) and Section 194S, the tax shall be deducted u/s. 194S, consequent to the overriding effect of Section 194S.

Further, once tax is deducted under section 194S of the Act, tax would not be required to be deducted under section 194Q of the Act.

Receipt of VDAs as consideration for services

13.74 This is a case where the consideration for transfer of VDA is being provided in kind. Hence, he shall be responsible for deducting TDS under Section 194S (subject to conditions therein). Please note where the payer deducts tax under Section 194S, it shall not absolve the payee from deduction of tax under the relevant provisions. For example, where an auditor receives fees for his professional services in Bitcoins. Here, while the auditor may have to comply with TDS under section 194S, the client may have to comply with TDS under section 194J. There could be other situations where TDS provisions applicable to both the payer and payee.

14. Implications under GST: Constitutionality, Classification & Taxability

14.1 Goods and Services Tax (GST) is a comprehensive levy on supply of goods or services. The levy would have dependencies on the Constitutional provisions, its classification as goods or services and the time and place of supply.

Constitutional Provisions: GST

14.2 Article 265 provides that “No tax shall be levied or collected except by authority of law”. Article 245 provides that Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State.

14.3 In order to enable levy of GST, as a means of cooperative federalism, by ensuring retention of fiscal autonomy between State and Centre, Article 246A was inserted, to provide that the Parliament and the Legislatures of every State, have the power for making laws with respect to goods and services tax imposed by the Union or such State. In this regard, Article 269A requires apportionment of GST collected in the manner to be provided by the Parliament on the recommendation of the GST Council.

14.4 Article 269A(5) provides that the Parliament may, by law, formulate principles

- for determining place of supply of goods or services or both;
- for determining when a supply of goods or services or both takes place in the course of inter-State trade or commerce.

14.5 Article 286(2) provides that the Parliament may, by law, formulate principles, for determining:

- when a supply of goods or services or both takes place outside the State;
- when a supply of goods or services or both takes place in the course of import of goods or services or both, into the territory of India.
- when a supply of goods or services or both takes place in the course of export of goods or services or both, out of the territory of India.

14.6 In terms of the above, Article 245(1) provides that Parliament may make laws for the whole or any part of India and the legislature of a state may make laws for the whole or any part of the state. Article 245(2), provides that no law made by Parliament shall be deemed to be invalid on the ground that it would have extra-territorial operation. This apparent dichotomy manifest through Article 245(2) has been explained by the Supreme Court in the case

of **GVK Industries Limited Vs. ITO** [(2011) 332 ITR 130] and in the case of **Sondur Gopal Vs. Sondur Rajini** [AIR 2013 SC 2678]. It has been held that laws made by one state cannot have operation in another state. A law which has extra-territorial operation cannot directly be enforced in another state but such a law is not invalid and is saved by Article 245(2) of the Constitution. But clause (2) does not mean that law having extra-territorial operation can be enacted which has no nexus at all with India. Unless such contingency exists, Parliament shall be incompetent to make law having extra-territorial operation.

- 14.7 The Supreme Court in the case of **M/s. Electronics Corporation of India Limited Vs. Commissioner of Income Tax** [AIR 1989 SC 1707], it was held that unless a nexus with something in India exists, Parliament would have no competence to make the law. Article 245(1) empowers Parliament to enact law for the whole or any part of the territory of India. The provocation for the law must be found within India itself. Such a law may have extra-territorial operation in order to sub-serve the object and that object must be related to something in India. It is inconceivable that a law should be made by Parliament in India which has no relationship with anything in India. In this regard, any laws enacted by Parliament with respect to extra-territorial aspects or causes that have no impact on or nexus with India would therefore be ultra-vires.
- 14.8 Digital transactions, particularly in the case of virtual digital assets, have the ability to be executed remotely. It may not require the physical presence for undertaking the transaction and the traceability of the transactions, to the person executing them, becomes impossible. Irony of the transaction, is that the distributed ledgers, which have record of the transaction, are encrypted and kept or stored in nodes, which may not be known as to where and the person executing may use multiple devices, with one for executing, being kept outside India and the other for viewing the transaction, which is kept in India. Also, a proficient dealer in such transactions, may keep an entity in a jurisdiction which is favoured to transactions in digital transactions, despite they controlling and executing them, while sitting in India, the regulators will not be able to demonstrate nexus, for bringing them to be taxed in India.
- 14.9 In such circumstances, in terms of the framed place of supply rules, transactions which are executed outside India but when the interest or title in them, passes through parties, with usual places of residence in India, whether it could be said to have sufficient nexus with India, would need to be tested judicially and constitutionally, particularly when they are shielded, as executed from entities incorporated outside India or when unaccounted monies are deployed, leaving no trace for regulators to draw nexus or get information of who, when and where the transactions is executed.

Classification under GST

- 14.10 There is no specific definition of virtual digital assets under the GST law. Adopting the meaning provided in the Income Tax Act or the draft bill to regulate crypto currencies, it is understood that they are appropriately defined as 'an information or code or number or token, that are secured or generated using cryptography, having digital representation of value, satisfying the test of having inherent value or having a store of value with a unit of account which can be transferred, stored or traded electronically'.
- 14.11 The analysis would lead to determining whether cryptocurrencies or NFT's or virtual digital assets, are to be classified as 'goods' or 'services' or neither as goods or services.
- 14.12 Section 2(52) of Central Goods and Services Tax Act, 2017 (CGST Act) defines 'goods' to mean 'every kind of movable property other than money and securities but includes actionable claim, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before supply or under a contract of supply';
- 14.13 Section 2(102) of CGST Act, defines 'services' to mean 'anything other than goods, money and securities but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form, currency or denomination, to another form, currency or denomination for which a separate consideration is charged';
- 14.14 Before we analyse whether virtual digital assets is goods or services, let us consider whether they can be regarded as 'Money', or 'Securities' or 'Actionable Claim':

Money

- 14.15 The Central Goods and Services Tax Act, 2017 defines 'money' under Section 2(75) to mean "the Indian legal tender or any foreign currency, cheque, promissory note, bill of exchange, letter of credit, draft, pay order, traveller cheque, money order, postal or electronic remittance or any other instrument recognised by RBI, when used as a consideration to settle an obligation or exchange with Indian legal tender of another denomination but shall not include any currency that is held for its numismatic value." The table below, provides analysis to the term 'Money':

Money	Explanation of the meaning
<ul style="list-style-type: none"> Indian Legal Tender 	<ul style="list-style-type: none"> Legal Tender Money is anything recognized by law as a means to settle a public or private debt or meet a financial obligation is considered legal tender The RBI Act of 1934, which grants the Central Bank the sole authority to issue banknotes, states that every banknote shall be legal tender in payment for the amount expressed therein in any place in India RBI defines legal tender as 'a coin or a banknote that is legally tenderable for discharge of debt or obligation Coins issued u/s. 6 of Coinage Act, 2011 shall be legal tender in payment or on the account to a limited extent of value Cryptocurrencies are not recognized as legal tender in India
<ul style="list-style-type: none"> Any foreign currency 	<ul style="list-style-type: none"> A legal tender of a country outside India The term 'currency' is not defined in the RBI Act, 1934 nor in the Banking Regulation Act, 1949 nor in the Payment and Settlement Systems Act, 2007 and nor in the Coinage Act, 2011 FEMA defines the words 'currency', 'currency notes', 'Indian currency' and 'Foreign currency'. A 'foreign currency' is as a currency other than Indian Currency. The term does not mention, of a particular country. Bitcoin, Ethereum and other digital currencies, are not attached to any country and whether they can be considered as 'foreign' 'currency'. Accordingly, for it be foreign currency, it should also satisfy the meaning of being currency FEMA defines "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 RBI. Digital currencies do not fall within the enumerated description of currency and nor has RBI notified them as similar instrument. Hence, crypto currencies are not currency, within the meaning of FEMA.

Money	Explanation of the meaning
	<ul style="list-style-type: none"> Bitcoin, a crypto currency, is accepted as legal tender by two countries (El Salvador and Central African Republic). While it is a legal tender in those two countries, it is not issued by those two countries, but merely accepted by them as a legal tender. There are views which express the possibility of Bitcoin being considered as foreign currency, as it is accepted as legal tender in those countries. However, in order to be a foreign currency, it should also satisfy the test of being a currency and India, does not recognize 'bitcoin' as currency. Bitcoin is not issued by any Government and it is not universally accepted currency. Similar example is a currency by name 'Kailashian Dollar' issued by tainted Nityananda, in territory declared as sovereign, in a location called Kailasa, at an unidentified place on the globe. Accordingly, giving recognition of legal tender status by a Country would not make Bitcoin as a 'foreign currency' unless it is regarded as 'currency' under FEMA. However, it may be appropriate for RBI to specifically specify or prohibit them from being considered as 'foreign currency'.
<ul style="list-style-type: none"> Extended terms as currency 	<ul style="list-style-type: none"> Crypto currencies having digital representation of value are used as medium of exchange for goods and services but they do not fall within the meaning of being 'cheque, promissory note, bill of exchange, letter of credit, draft, pay order, traveller cheque, money order, postal or electronic remittance' and nor are they recognized as 'other instrument' by RBI.

14.16 Accordingly, while crypto currencies have the attributes of money, they are not recognized as legal tender or currency in India and for reasons mentioned, not considered as 'foreign currency' or are they recognized as 'other instrument' by RBI and hence virtual digital assets or crypto currencies will not be regarded as 'Money'.

Securities

14.17 The Central Goods and Services Tax Act, 2017 defines "Securities" under Section 2(101) as "shall have the same meaning as assigned to it in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956"

14.18 The term “securities” the Securities Contracts (Regulation) Act, 1956, is defined to include –

- (i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company 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;
- (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 declared by the Central Government to be securities; and
- (iii) rights or interests in securities;”

14.19 Perusal of the term ‘Securities’ would evidence that virtual digital assets will not fall within the assigned meaning of securities under any of the enlisted sub-clauses except for specified class of digital assets as ‘derivative’, which are explained below.

14.20 The term ‘derivative’ is defined in:

Section 43U(a) of Reserve Bank of India Act, 1934, to mean *‘an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called “underlying”), or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by the Bank from time to time’*

Section 2(ac) of Securities Contracts (Regulation) Act, 1956 to include:

- (A) *a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;*

- (B) *a contract which derives its value from the prices, or index of prices, of underlying securities;*
- (C) *commodity derivatives; and*
- (D) *such other instruments as may be declared by the Central Government to be derivatives”*

14.21 Cryptocurrencies other than ‘security tokens’ and ‘stablecoins’ will clearly not fall within the meaning of derivative, as the value of crypto currencies is not derived from underlying security nor are they not issued by anyone and nor does it have a contract to repay the value which it represents. However, ‘security tokens’ and ‘stablecoins’ have an underlying asset, basis which they derive their value and allow the holders to redeem them at a future date on a predetermined base. While ‘stablecoins’ are more akin to being a form of money, the ‘security tokens’, have the ability to be regarded as derivative. However, Central Government and RBI, have not notified such security tokens as derivatives. Given the same, it would be need to be analysed on case to case basis, whether such security tokens would fall within the meaning of Securities.

Actionable Claim

14.22 Actionable claim is defined as ‘goods’ under GST, where the definition of goods specifically includes actionable claim. However, as per Schedule III of CGST Act 2017, an actionable claim other than lottery, betting and gambling are ‘neither supply of goods nor services’.

14.23 GST law does not separately define an Actionable Claim but draws or derives its meaning from Section 3 of Transfer of Property Act, 1882, which is defined as below:

“actionable claim means a claim to any debt, other than a debt secured by mortgage of immovable property or by the hypothecation or pledge of movable property, or to any beneficial interest in movable property not in the possession, either actual or constructive, of the claimant, which the civil courts recognises as affording grounds for relief, whether such debt or beneficial interest be existent, accruing, conditional or contingent”.

14.24 In other words, an actionable claim would mean a claim related to unsecured debt and to a beneficial interest in a moveable property, not in his procession. Crypto currencies or virtual digital assets (other than utility tokens) are not a claim to any unsecured debt. The person in possession, enjoys the inherent value of the currency which functions as a store of value or a unit of account, including its use in any financial transaction or

investment, that can be transferred, stored or traded electronically. It does not in any manner represent a claim related to any unsecured debt or to a beneficial interest in a moveable property, which is not possession. Accordingly, crypto currencies other than utility tokens, cannot be regarded as ‘actionable claims’.

14.25 However, utility tokens, which are based on cryptography and blockchain, are more akin to being regarded as ‘actionable claims’ as the utility tokens represent a claim in relation to an underlying moveable property or services. In such cases, they ought to be regarded as actionable claims and not be subjected to GST. Such tokens, depending on the terms and conditions could also amount to a voucher under GST, in which case, the point of taxation is shifted to a time, at which the token is actually exchanged for goods or services, unless they are for ascertained goods or services.

14.26 Accordingly, the below table summarizes the implications for crypto currencies, on whether they could be regarded as money, securities or actionable claim:

Classification under GST	Virtual Currency	Security Tokens	Utility Tokens
Whether as Money	No	No	No
Whether as securities but not derivative	No	No	No
Whether as derivative	No	Possible	No
Whether as actionable claim	No	No	Possible

Why digital assets not classifiable as ‘services’

14.27 The term ‘services’ is defined under GST to meaning anything other than goods, money and securities. Accordingly, a supply not falling within the meaning of goods, would be ordinarily, be regarded as ‘services’. In this regard, Schedule II, deems specified activities to be either supply of goods or as supply of services and Schedule III, deems specified activities to be neither supply of goods nor supply of services.

14.28 Services, unless deemed otherwise or as such, are amenities, benefits, facility, support (technical or otherwise) provided by a person to another, as performance of any work. Services are intangible in nature, which cannot be stored, transferred or returned back. However, goods may be tangible or intangible material, commodity or things, which have utility, which can be bought and sold or transferred from one person to another. Virtual digital assets have utility, which can be used as a medium of exchange for

procurement of goods or services, which can be stored, as having an investment value and which can be sold or transferred from one person to another. Virtual digital assets, retain its identity and is attached to the owner, who can use the same, as a form of money or currency, but which is however, not recognized as legal tender or money.

14.29 Accordingly, merely because virtual digital assets are intangible in nature or that their value is not stable or for certain reasons, they are not considered as commodity or goods, they will not automatically be regarded as 'services'. Virtual digital assets, in the form presented, is not services and is comparable to digital gold, whose value fluctuates to demand and supply.

14.30 Services connected with virtual digital assets i.e. the activity of mining i.e. creation of new digital assets or validation of transactions or the services of exchanges which facilitate transfer of digital assets from one person to another, will be regarded as services, for the reasons mentioned in the ensuing paragraphs.

Classification as Goods

14.31 The meaning of the term 'goods', is defined under the GST law, to mean:

- a) every kind of movable property;
- b) other than money and securities;
- c) but includes actionable claim, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before supply or under a contract of supply

14.32 The Article 366(12) of the Constitution of India defines the term goods as 'goods include all materials, commodities, and articles'. The terms 'materials, commodities and articles', refers to moveable property. The term movable property has not been defined in the GST law and Section 3(36) of General Clauses Act, 1897 defines the term 'movable property' to mean 'property of every description, except immovable property', while 'immovable property' is defined in Section 3(26) of the General Clauses Act, 1897 to include land, benefits to arise out of land, and things attached to the earth, or permanently fastened to anything attached to the earth."

14.33 On whether sale of electricity is goods for the purposes of imposition of sales tax, the Hon'ble Supreme Court in the case of **CST, Indore Vs. Madhya Pradesh Electricity Board, Jabalpur** [(1969) 1 SCC 200 (SC)], noted that the definition of the term goods meant all kinds of movable property and included all materials, articles and commodities. It was held that electric energy is goods as it can be transmitted, transferred, delivered, stored, and

possessed in the same way as any other movable property. If there can be sale and purchase of electric energy, then it is intended to be covered by the definition of goods.

14.34 The Hon. Supreme Court, in the case of **Delhi Cloth and General Mills. Co. Ltd.**, [1977 (1) ELT (J199) SC] held as under;

“On the meaning of the word ‘goods’ an interesting passage is quoted in the Words and Phrases, Permanent Edition, Vol. 18 from a judgment of a New York Court thus: -

‘The first exposition I have found of the word “goods” is in Bailey’s Large Dictionary of 1732, which defines it simply “merchandise”; and by Johnson, who followed as the next lexicographer it is defined to be movable in a house; personal or immovable estates; wares; freight; merchandise.’

Webster defines the word ‘goods’ thus: -

(1) movables; household furniture; (2) Personal or movable estate, as horses, cattle, utensils, etc., (3) Wares; merchandise; commodities bought and sold by merchants and traders.”

These definitions make it clear that to become ‘goods’ an article must be something which can ordinarily come to the market to be bought and sold, and that satisfy human wants and provide utility.”

The Hon’ble Supreme Court brought out the marketability, movability and utility test, to categorize an item as ‘goods’. This view was also confirmed by the Hon’ble Supreme Court in the case of **Ambalal Sarabhai Enterprises** [1989 (41) ELT (214) SC].

14.35 The Hon’ble Supreme Court in the case **Associated Cement Companies Ltd Vs. Commissioner of Customs** [2001 (128) ELT (21) SC], held that all tangible movable articles are goods for levy of customs duties under Section 12. It held that when technical advice or information technology, as an intangible asset, was put on a media, whether paper or cassettes or diskettes or any other thing, that what is supplied becomes chattel and that drawings, designs, manuals and technical material are goods liable to customs duty.

14.36 In a landmark decision, the Hon’ble Supreme Court in the case of **Tata Consultancy Services Vs. State of Andhra Pradesh** [2004 (178) ELT (22) SC] held that ‘Goods’ includes both tangible and intangible movable properties, materials, commodities and articles and also corporeal and incorporeal materials. It is not a term of art and its meaning varies from statute to statute. Further, on the question whether certain software would fall within the meaning of goods under the state sales tax law and it was held by the

majority that the term goods used in the Constitution of India is very wide and under the relevant Act it includes all types of movable properties irrespective of tangible or intangible and a transaction sale of computer software is a sale of goods within the meaning of relevant sales tax act. In the concurring opinion, Hon'ble Justice Sinha laid down a three-part test for software to classify as goods i.e. (a) its utility (b) capable of being bought and sold (c) capable of being transmitted, transferred, delivered, stored and possessed.

14.37 The Hon'ble Supreme Court in the case of **Vikas Sales Corporation Vs. CCT** [2017 (354) ELT (6) SC] observed that replenishment licences (REP licence) allow holders to import goods without payment customs duty, having their own value and could be bought and sold as such, when the holder of the license was unable to utilize them on import goods. The Court held that they were not chose-in-action, actionable-claim or title deed. They were property freely bought and sold in market and that definitions of "goods" and "property" in Sale of Goods Act, 1930 were in material particulars similar to definition of "goods" in Tamil Nadu, Karnataka and Kerala Sales Tax Acts, all of which uniformly say "goods" mean "every kind of movable property" (Sale of Goods Act) and "all kinds of movable property" (Tamil Nadu, Karnataka and Kerala Acts). The Court also held that REP Licence/Exim Scrip's were not securities within meaning of Clause (h) of Section 2 of Securities Contracts (Regulation) Act, 1956 and accordingly the Hon'ble Court held sale of REP Licenses are "goods" in Tamil Nadu, Kerala and Karnataka Sales Tax Acts as well as Central Sales Tax Act.

14.38 In a landmark decision on crypto currencies, the Hon'ble Supreme Court in the case of **Internet and Mobile Association of India Vs. Reserve Bank of India**, passed its judgment on 04-Mar-2020, lifting the ban imposed by RBI through its circular dated 06-Apr-2018, which prohibited its regulated entities (i.e. financial institutions like banks) from dealing in, or facilitating banking transactions, relating to virtual currencies. In this decision, the Hon'ble Supreme Court observed the following:

- (i) If an intangible property can act under certain circumstances as money (even without faking a currency) then RBI can definitely take note of it and deal with it. Hence it is not possible to accept the contention of the petitioners that they are carrying on an activity over which RBI has no power statutorily and that RBI has the requisite power to regulate or prohibit any activity of this nature.
- (ii) An important aspect to be taken note of is that virtual currencies cannot be stored anywhere, in the real sense of the term, as they do not exist in any physical shape or form. What is actually stored is the private keys,

which can be used to access the public address and transaction signatures

- (iii) The petitioners claim that today virtual currency is not money or other legal tender, but good/tradable commodity and hence RBI has no role in regulating/banning the same. RBI has also taken a stand that virtual currency are not recognized as legal tender, but they seek to justify the impugned decisions, on the ground that VCs are capable of being used as a medium of exchange

14.39 In summary, the following summarizes the characteristics in goods and how virtual digital assets, in the form in which they are, satisfy the meaning and character of being regarded as ‘goods’:

Characteristics of goods	Does crypto currencies satisfy condition of ‘goods’
It is Moveable	Yes - Digitally transferable
Can be stored (before consumption)	Yes - On distributed ledger
Transferable from one person to another	Yes
It has utility	Yes
It is Marketable	Yes
It is not ‘money’	Yes
It is ‘securities’	Yes (other than security tokens)

14.40 Per the above, the term ‘movable property’ or ‘Goods’, has been judicially held to include both corporeal and incorporeal property. It can be observed that cryptocurrencies are intangible that can be bought and sold, transmitted, transferred, delivered, stored, and possessed, electronically. Private or virtual digital assets such as Bitcoin, Ethereum, etc., are used for various purposes like a store of value, transfer of value, micropayments, and decentralized applications. Therefore, these features and the demand for cryptocurrencies for these purposes substantiates their utility. Therefore, based on the above analysis and based on the text of the law, it can be concluded that virtual digital assets or crypto currencies, other than certain currencies such as security tokens or utility tokens, are closest to be regarded as ‘goods’ under the GST law and ought to be classified as such.

Taxability & Place of Supply

14.41 The taxability under GST, would depend on the nature of the transaction or supply. We have seen that transactions in crypto currencies, can be broadly classified into the following and the analysis on the taxability is therefore given separately for each:

(i) Generating new currencies where the recipient is not known:

Taxable as	Registration State	Place of Supply	Rate
Not taxable	Not applicable	Not applicable	Not applicable
Reasoning	<p>In a mining activity, involving generation of new coins, say for Bitcoin, the miner i.e. person undertaking to mine, solves complex software mathematical algorithms and puzzles, and of the many who undertake to solve, the person who solves the puzzle, earliest among others, is rewarded with a bitcoin. There is no contract for supply between the miner and the recipient, but the reward is built in the bitcoin program, where the miner gets rewarded for undertaking the mining of new coins.</p> <p>In this case, there is no Supplier-recipient contract and it is not known, who has received the services or paid for the bitcoin earned by the miner. It functions similar to a reward in game of skill, with no information on who has organized the game or who has provided the reward.</p> <p>Accordingly, it can be argued that the activity of bitcoin or crypto mining, where the recipient is unknown, would not be leviable to GST. The authorities may argue otherwise, as the liability to GST, is on the person providing the service and the charging section, rather intentionally, does not depend on the need to render supply of taxable services to 'another'. Mere supply, for a consideration would attract the levy of GST. However, in such cases, the determination of place of supply, would also fail, as the location of recipient is unknown and in the absence of specific provision to determine place of supply in such cases, the charge to GST, ought to also fail.</p>		
Suggestion	Provisions determining place of supply, should be suitably amended to determine liability in case of mining of crypto currency, where the recipient, is not known		

(ii) Generating new currencies where the recipient is known:

Taxable as	Registration State	Place of Supply	Rate
Services	Location of supplier	Location of recipient	18%
Reasoning	<p>In a mining activity involving generation of new coins, if the person paying the consideration i.e. digital assets, is known, then the miner i.e. person undertaking to mine or generate new coins or currencies, will be considered as undertaking 'provision of technical services' involving knowledge of computer science engineering. This process may involve, solving of complex software mathematical algorithms and puzzles or such other defined requirement, and ordinarily, of the many who undertake, the person who completes the task earliest among others, would be rewarded with newly generated crypto currency.</p>		
	<p>In this case, there is contract of supply, between the miner (supplier) and the recipient, to undertake the activity of mining, which is technical or engineering services. The taxability would be determined, in the manner given below.</p> <ul style="list-style-type: none"> • In case the miner (supplier) and the recipient, both are located outside India, then the transaction is not taxable. • In case the miner (supplier) is in India but recipient (supplier of crypto currency) is located outside India, then the supply of mining services, ought to be considered as exports. The liability to customs duty, on receipt of crypto currency, by miner, would be litigative. Crypto currencies can be accessed by wallets and such wallets, can be accessed from any place i.e. within or outside India. Merely because the information is available or accessed in India, import into India, cannot be established. Accordingly, it can be argued that unless the provisions are suitably amended in the Customs law, customs duty cannot be levied, as import into India, is not established, while authorities may consider so. • In case the miner (supplier) is located outside India but recipient (supplier of crypto currency) is in India, then the recipient would be liable to GST on reverse charge, considering the recipient to be engaged in business activity. 		

(iii) Mining i.e. validation of transactions, where recipient is unknown:

Taxable as	Registration State	Place of Supply	Rate
Not taxable	Not applicable	Not applicable	Not applicable
Reasoning	<p>In a mining activity, involving validation of blockchain transactions, the miner gets rewarded with new crypto currencies that are introduced into blockchain. The person undertaking to validate the transactions, solves complex software mathematical algorithms and puzzles, and of the many who undertake to solve, the person, who solves the puzzle earliest among others, is rewarded with a crypto currency. There is no contract for supply between miner and a particular recipient but the reward is built in the crypto currency program, where the miner, gets rewarded for undertaking the validation of blockchain transactions.</p> <p>In this case, there is no Supplier-recipient contract and it is not known, who has received the services or paid for the bitcoin earned by the miner. It functions similar to a reward in game of skill, with no information on who has organized the game or who has provided the reward.</p> <p>Accordingly, it can be argued that the activity of bitcoin or crypto mining, involving validation of blockchain transaction, where the recipient is unknown, would not be liable to GST. The authorities may argue otherwise, as the liability to GST, is on the person providing the service and the charging section, rather intentionally, does not depend on the need to render supply to 'another'. Mere supply, for a consideration would attract the levy of GST. However, in such cases, the determination of place of supply, would also fail, as the location of recipient is unknown and in the absence of specific provision to determine place of supply in such cases, the charge to GST, ought to also fail.</p>		
Suggestion	<p>Provisions determining place of supply, should be suitably amended to determine liability in case of mining of crypto currency, where the recipient, is not known</p>		

(iv) Mining i.e. validation of transactions, where recipient is known:

Taxable as	Registration State	Place of Supply	Rate
Services	Location of supplier	Location of recipient	18%
Reasoning	<p>In a mining activity, involving validation of blockchain transactions, if the person paying the consideration i.e. digital assets is known, then the miner i.e. person undertaking to validate blockchain transactions, will undertake provision of technical services involving knowledge of computer science engineering. This process involves either solving complex software mathematical algorithms and puzzles or validation of transactions by proof of stake method, and the person, who solves the puzzle earliest among others or in the manner specified by the program, is rewarded with newly generated crypto currency.</p> <p>In this case, there is contract of supply, between the miner (supplier) and the recipient, to undertake the activity of mining, which is technical or engineering services. The taxability would be determined, in the manner given below.</p> <ul style="list-style-type: none"> • In case the miner (supplier) and the recipient, both are located outside India, then the transaction is not taxable. • In case the miner (supplier) is in India but recipient (supplier of crypto currency) is located outside India, then the supply of mining services, ought to be considered as exports. The liability to customs duty, on receipt of crypto currency, by miner, would be litigative. Crypto currencies can be accessed by wallets and such wallets, can be accessed from any place i.e. within or outside India. Merely because the information is available or accessed in India, import into India, cannot be established. Accordingly, it can be argued that unless the provisions are suitably amended in the Customs law, customs duty cannot be levied, as import into India, is not established, while authorities may consider so. • In case the miner (supplier) is located outside India but recipient (supplier of crypto currency) is in India, then the recipient would be liable to GST on reverse charge, considering the recipient to be engaged in business activity. 		

(v) Transaction in crypto currencies, where the buyer and seller are in India:

Taxable as	Registration State	Place of Supply	Rate
Goods	Location of Seller	Location of Buyer (Delivery Location)	18%
Reasoning	Sale of crypto currencies being supply of goods, will be taxed as such. There will be challenge to determine the situs of location of buyer and seller, as the transaction is undertaken digitally		
Suggestion	<p>Government should introduce a special and separate rate for supply of crypto currencies and the rate should be same as sale of digital gold or precious metals, but not more than 3%. Given the rate of taxes to low, it will encourage disclosure of taxable transactions.</p> <p>Provisions determining place of supply should be suitably amended, in cases where the buyer is registered or is not registered, under GST</p> <p>Rules may be amended to provide the mechanism to adopt the rate for conversion of crypto currencies to INR equivalent</p>		

(vi) Sale of crypto currency, where the seller is in India but buyer is located outside India:

Taxable as	Registration State	Place of Supply	Rate
Goods	Location of Seller	Location of Buyer	Zero rated
Reasoning	Transaction will be treated as export of goods. There will be challenge to determine the situs of location of buyer and seller, as the transaction is undertaken digitally. The conditions for realization of export proceeds, will also need to be fulfilled.		
Suggestion	<p>Government should introduce a special and separate rate for supply of crypto currencies and tax rate should be same as sale of digital gold or precious metals and be taxed, not more than 3%. Given the rate of taxes to low, it will encourage disclosure of taxable transactions.</p> <p>Provisions determining place of supply should be suitably amended, for transactions undertaken digitally.</p>		

(vii) Transaction in crypto currencies, where the buyer is in India but seller is outside India or where the buyer purchases crypto currency as investments, not in the course of business:

Taxable as	Registration State	Place of Supply	Rate
Goods	Not applicable	Not applicable	Presently not leviable to GST
Reasoning	<p>Import of goods in electronic form is not subject to GST under reverse charge. Purchases that are not in the course of business is also not subject to GST</p> <p>The liability to customs duty on import of crypto currency, would be litigative. Crypto currencies can be accessed by wallets and such wallets, can be accessed from any place i.e. within or outside India. Merely because the information is available or accessed in India, import into India, cannot be established. Accordingly, it can be argued that unless the provisions are suitably amended in the Customs law, customs duty cannot be levied, as import into India, is not established, while authorities may consider so.</p>		
Suggestion	<p>Government should amend the law to tax integrated GST on reverse charge in lieu of levy of customs duty with appropriate HSN under customs and GST for such levy</p> <p>Rules may be amended to provide the mechanism to adopt the rate for conversion of crypto currencies to INR equivalent</p>		

(viii) Services connected with transfer of such currencies i.e. crypto exchanges

Taxable as	Registration State	Place of Supply	Rate
Services	Location of supplier	Location of recipient	18%
Reasoning	<p>Transaction of crypto exchanges, which provide services connected with wallet, storing, purchase, sale, transfer of crypto currencies or exchange to FIAT currency, would be regarded as supply of services and taxed as such.</p>		
Suggestion	<p>Government may consider the need to require crypto exchanges deduct GST TDS from payments/ transfers made to seller, whether in digital currency or conversion to FIAT currency</p> <p>Rules may be amended to provide the mechanism to adopt the rate for conversion of crypto currencies to INR equivalent</p>		

(ix) Domestic supply of goods or services in exchange of crypto currencies

Taxable as	Registration State	Place of Supply	Rate
Barter	Location of supplier	Location of recipient	Rate applicable based on nature of supply
Reasoning	Supply of goods or services in exchange of crypto currencies, will be considered as two separate transactions, as barter of goods or services. Taxability will be determined based on taxability of supplier and recipient, for mutual exchange of good or services		
Suggestion	Provisions determining place of supply should be suitably for determination in cases where the buyer is registered or not registered under GST Rules may be amended to provide the mechanism to adopt the rate for conversion of crypto currencies to INR equivalent		

14.42 The current tax structure under GST is plagued with inability to determine the proper charge, the situs of supply and the appropriate valuation. It would be appropriate for Government to bring about specific provisions under GST, to determine and collect the tax leviable. In this regard, it would be appropriate for Government to issue the draft scheme for levy of tax on crypto currencies, for recommendations from the industry, before implementing and adopting the same. The Government may also consider, amendment to Schedule II of the CGST Act, to deem a transaction in crypto currencies as supply of services, with suitable amendments in customs law, place of supply and valuation, to determine and collect the tax, in a simple determinative manner. Suitable legislative provisions may be introduced for companies providing wallet services and crypto exchanges, to determine, the supplier and recipient of such digital transactions.

14.43 The above recommendations will hold good, even in cases where the Government seeks to ban transactions in crypto currencies, as determination of tax liability would be required even when undertaken in prohibited transactions. In such cases, the charge and situs be determined by appropriate amendment to the statute, to avoid a situation where the levy would fail, when tax cannot be determined.

15. Use Case of Blockchain Technology

- 15.1 Blockchain technology, may be nascent in its development stage but by embracing decentralization, with promise to overcome monopolization of the web by large internet companies, it is allowing the web being built, operated and managed by any user, on a permission less system.
- 15.2 Besides cryptocurrency, blockchain provides various applications in financial services, supply chains and the public sector by offering enhanced security, greater transparency, and instant traceability and in order to support blockchain applications, many Governments are legislating new laws to promote the use of blockchain.
- 15.3 The use case i.e. how blockchain can be applied to business applications, is becoming wider and emerging strongly, some of which are illustrated below:

Sector	Select Use Case Scenarios
Financial Services	Blockchain offers various capabilities to improve investment management processes by improving: <ul style="list-style-type: none">• by enabling everyone to access a single source of truth easily• transaction validation and transparency• improving the overall data security stored in immutable records
Internet of Things	“Patently Walmart” is a blockchain solution for internet of things, where each smart device receives a unique identifier and users hold a password accessible via their smartphones, with all transactions and messages being encrypted and going through a secured network. All configuration changes to the devices are stored in a tamper-proof blockchain solution making all configuration changes auditable.
Assets of an Organisation	Blockchain offers digitization of assets with sensors allowing organizations to label assets and provide a transparent tracking system. Blockchain can store, manage, protect and transfer all this information.
Smart contracts	Smart contracts are tested application using blockchain technology. These contracts the intermediary and ensure adherence to conditions in a contract between two parties and disbursing defined payments.
Passports, Personal IDs, Marriage Certificates	The blockchain could make record-keeping more reliable by encrypting personal identification IDs and allowing citizens to access this information. Allowing control of their digital data and the manner in which it is utilized by different parties.

- 15.4 Government of every country, large organizations, banking sector, etc., are extensively making use of blockchain technology, to secure processes, bringing digital transformation, ensuring supply chain resilience that bring sustainability to business. Blockchain, showcased as web 3.0, is indeed the technology of the future.

16. Industry perspective

16.1 The authors to this booklet, felt the need to obtain perspective from Industry, who could comprehend its objective. The authors approached, a founder of a crypto currency exchange to transact in digital assets and a founder of known cybersecurity firm, who together bring extensive domain knowledge and also have the actual experience on the use case of digital assets. Their views, would provide an overall perspective, which the authors desire to provide to the readers of this booklet.

16.2 Mr. Ashish Singhal, who is the Co-founder and CEO, CoinSwitch, as one of the largest crypto currency exchanges in India, explains the need for clarity in regulations on transactions in crypto currencies and how India, could lead the intensifying revolution of Web3, with needed regulatory support to such transactions and the potential that the technology use-cases of blockchain can bring, in his own words, as below:

- (a) The Crypto industry has grown by leaps and bounds over the last decade. Once a field of interest to a closed circle of technologist's and purists, today Crypto has been adopted by millions of retail users and is increasingly being embraced by large institutions. The market has embraced Crypto as an asset class.
- (b) Crypto has enabled millions of first-time investors in India, who identify with and relate to the internet-native and transparent process of digital assets. This has opened new ways for India to deepen and enhance capital flow and investment culture. The Crypto industry can work alongside traditional banking and finance to the benefit of India's economic and societal objectives.
- (c) India now needs regulatory clarity to enable responsible innovations to achieve these goals. Regulations can standardize best practices for the industry and provide guardrails for investors. The absence of regulations, on the other hand, introduces additional uncertainties, exposing users to bad actors and malpractices.
- (d) Forward-looking regulations will also help India to unlock the true potential of Crypto technology: Open and distributed internet that gives India's creators, innovators, and startups a better deal than they have now.
- (e) While today Crypto's use-cases are largely in finance, the technology can be leveraged to build a new form of the internet called Web3 where the core infrastructure is not centralized and controlled by a

few big companies, but is instead open and distributed. This benefits India—home to over 700 million internet users and millions of tech workers.

- (f) India has a well-established track record of innovating on open protocols: Simputer and Kaii in the early 2000s, the contributions of Indian developers on the Android ecosystem, and lately government-backed projects such as the Open Network for Digital Commerce (ONDC).
- (g) We can now take a giant leap forward by establishing the expertise in developing and shaping Web3, and be the driving force of this new technological revolution. Crypto can truly be a force-multiplier for India.

16.3 Mr. Dharshan Shanthamurthy, who is the Founder and CEO, SISA Information Security, one of India's largest pure-play cybersecurity company, who explains in his own words, on how immutability in the blockchain technology would propel its large use-case, as below:

- (a) Blockchain has proven its use-case in the financial sector including banking, which is also the focus of the Government. However, there are multitude of blockchain implementation opportunities which are well beyond the tested boundaries of such financial sectors. The principle of distributed ledgers in blockchain, lends itself to any industry having a database that requires a trustless and immutable storage system. The distributed nature of the database makes it extremely secure and transparent, as multiple users (nodes) in a blockchain network have a copy of the database and each such node, works with several other nodes, to verify changes made to the database, thereby creating a system of transparency while providing security.
- (b) Blockchain has found success in many applications currently deployed, such as:
 - (i) Central Bank Digital Currency (CBDC) is a digital form of central bank money which is legal tender created and back by central bank. It's a claim against the central bank and not against a commercial bank or payment service provider. The Reserve Bank of India in its annual report of 2021-22 has revealed a structured approach on launching such currencies.
 - (ii) Supply-chain management, where interested parties can trace the trajectory of a product, from the starting point of its journey, to

the customer's doorstep and the parties collaborating in the supply chain journey can use blockchain platform to reduce time delays, added costs and human error

- (iii) Poll and voting on blockchain, with robust encryption and decentralization makes voting database incorruptible and each voting record easily verifiable
- (iv) Copyright and ownership protection for works of art, such as videos, music and paintings, have become necessary in the internet age. Digital copyright data, can be stored in blockchain, which is transparent and secure, with no third party being able to claim ownership without showing his proof of ownership
- (v) Smart contracts are simply programs stored on a blockchain that run when predetermined conditions are met. They typically are used to automate, the execution of an agreement, so that all participants can be immediately certain of its outcome, without involvement of an intermediary or time loss.

(c) It is believed that Web3, which has evolved from the stages of 'read-only web' to 'read and write web' and now to web which would not be controlled by any central agencies, using blockchain technology, could revolutionize the way we use internet and India is poised to play a pivotal role in this revolution, with its large skilled resources.

(d) Blockchain is in its early stage but promises to be large use-case, with growing technology and focus to make the technology more efficient, be it on energy use or time taken to verify or space required for its data storage and will soon, change the way we operate, in every given way, in a more reliable and efficient manner.

16.4 The authors to this booklet highlight that the views expressed by the industry experts should be considered as their personal views and it should not also be considered as endorsement by them, on the contents of this booklet or of the views expressed by the authors, in any manner.

17. Suggestion to the Government & Way Forward

- 17.1 Any new technology that brings the benefits of its use, would have host of legal, strategic, and operational challenges. While blockchain is known for its technological superiority, the virtual digital assets, being the most prominent use case, has ambiguity on legality, determination and computation of the tax, leading to large-scale evasion. The technology is so superior that challenges the existence of government as intermediary and can operate, without any risk of detection by the best of officers from the intelligence and evasion wing of the regulators.
- 17.2 The Government of all countries, have taken inordinate time to arrive at a consensus framework or policy that provides operating scheme to regulate the crypto currencies. Each country has framed policy that best suits its need, resulting in diverse meaning to a given technology and letting to collapse, a common international market for such transactions. The Government have also not been able to prevent misuse or bring disclosure of the transactions, given its uncertain behaviour, lacking transparency and not neglecting the interest of the stake-holders.
- 17.3 The Government is at the verge of implementing a bill to ban transactions in crypto currencies and bringing its own blockchain based, digital currency. However, we strongly urge the Government to refrain from neglecting the interest of the stake-holders that promote its monopolistic preference, which could potentially leave India, way behind from being a hub of technological supremacy.
- 17.4 The technology is indeed complex and calls for time and collective effort of the regulator and industry, to put a forward looking policy framework, that can propel its use, regulate its misuse and strengthen the economy. A rushed job is likely to impede innovation and cause greater harm to the overall business potential. A measured approach to regulation would be ideal. Some of the suggestions for the Government to consider are listed below:
- (i) Enact a standalone law to regulate crypto currencies but not to ban them
 - (ii) Have clear demarcation in roles of RBI, SEBI, MoF, that would be formed as inter-regulatory council, giving sufficient powers to regulate the stake-holders
 - (iii) Private digital currencies can co-exist along with central bank digital currency

- (iv) Necessary statutory amendments in laws pertaining to FEMA, RBI, Income Tax and Goods and Services Tax, apart from other necessary laws, to give force to progressive and supportive policy of the Government for crypto industry
- (v) India should become a natural destination of investments in crypto industry
- (vi) Create a specialised taskforce consisting of skilled and well-trained officers for enforcing the provisions of the law,
- (vii) Fostering partnerships with countries for effectively regulating crypto currencies

17.5 The stake-holders are cautioned to analyze the implications of their transactions in virtual digital assets and take steps that mitigate the risk and maximize the business potential and the use-case of this technology. Stakeholders should be privy to global policy of various Government and transact business that would legally withstand the test of law. We are hopeful that over the years, the framework will promote the industry and India will be considered, a natural destination, based on talent, resource and policy framework of the Government.

18. Glossary of blockchain terms and its meaning

Money	Explanation of the meaning
Address	Much like a URL, a blockchain address is the location to or from which transactions occur on the blockchain.
Alt-coin	Any coin or token other than Bitcoin.
Block	A group of transactions entered into a block-chain; analogous to a page of a ledger or record book.
Blockchain	A mathematical structure for storing digital transactions or data in an immutable, distributed, decentralized digital ledger consisting of blocks that are linked via cryptographic signature that is nearly impossible to fake, hack or disrupt.
Blockchain (Private Permissioned)	A block-chain that resides on a private network of computers that is only accessible to those with permission.
Blockchain (Public Permission-less)	A block-chain that resides on a network of computers around the world that is accessible to everyone.
Centralized	A system or process for which there is a singular (i.e., central) source of authority, control and/or truth.
Consensus Mechanism - Proof of Authority (PoA)	PoA is an alternative form to the PoS algorithm. Instead of staking cryptocurrency (wealth), in PoA you stake your identity. This means voluntarily disclosing who you are in exchange for the right to validate blocks. Any malicious actions you undertake as a validator will reflect back on your identity. PoA block-chains require a thorough form of KYC (Know Your Customer - a verification process that determines you actually are who you claim to be).
Consensus Mechanism - Proof of Burn (PoB)	PoB allows the miners to “burn” or destroy cryptocurrency which grants them the right to add blocks in proportion to the coins destroyed. Essentially, miners burn coins/tokens to buy virtual mining rigs that give them the power to mine blocks. The more currency burned by the miner, the bigger the ensuing virtual mining rig. To burn, miners send currency to a verifiably unspendable address. This process does not consume many resources, thus PoB is often called PoW without energy waste. Depending upon the implementation, miners are allowed to burn the native currency or the currency of an alternative chain, and in exchange, they receive a reward in the native currency of the block-chain.
Consensus Mechanism - Proof of Capacity (PoC)	PoC allows the mining devices in the network to use their available hard drive space to decide the mining rights, instead of using the mining device’s computing power (as in PoW) or the miner’s stake in the cryptocurrency (as in PoS).

Money	Explanation of the meaning
Consensus Mechanism - Proof of Stake (PoS)	In PoS, miners put up (i.e., "stake") some of the block-chain's cryptocurrency (e.g., ether for the Ethereum block-chain) in order to increase their chances of being selected to validate a block. The stake is locked up as a deposit to ensure the miner validates the block according to the rules. If the miner violates the rules, the deposit will be "burned" or destroyed. PoS is less resource intensive than PoW since fewer miners are racing to solve the mathematical formula.
Consensus Mechanism - Proof of Work (PoW)	In PoW, transaction data (block) + a random strings of digits (nonce of block) are repeatedly applied to a (hashing) mathematical formula by miners, until a desirable outcome is found (the proof of work). Other miners then verify the proof of work by taking the alleged input string and applying it to the same formulae to see if the outcome is indeed that what was presented. If the results are the same, the transaction is verified and added to the block-chain. As many miners are racing to solve the formula which requires a great deal of computing power, PoW is resource intensive.
DAO (Decentralized Autonomous Organization)	A governance structure without a central authority which rewards good behavior and penalizes bad behavior by a set of pre-defined rules which can only be changes by a vote, which typically requires a stake, adding risk to the process to discourage bad actors, amongst the participants.
DApp	Software which does not rely on a central system or database but can share information amongst its users via a decentralized database, such as a block-chain
Decentralization/ Decentralized	A system with no single point where the decision is made. Every node makes a decision for its own behavior and the resulting system behavior is the aggregate response.
Digital Signature	A mathematical scheme for verifying digital messages or documents satisfy two requirements - they have authenticity (from a known sender) and integrity (were not altered in transit).
Distributed	As opposed to decentralized, a distributed system shares processing and/or data across multiple nodes, but the decisions may still be centralized and use complete system knowledge.
Distributed Ledger Technology (DLT)	The larger class of technology of which block-chain is a subset. A digital system for recording the transaction of assets in which the transactions and their details are recorded in multiple identical copies at the same time with no central data store or administration.
Fiat	Legal tender the value for which is backed by a government or governmental body (e.g., US dollars, Euros)

Money	Explanation of the meaning
Fungible	The property an item of being exchangeable with other like items. Eg. INR or USD is fungible. Value of USD can be expressed in INR.
Immutability	The property of being unchangeable. Once a transaction has been added to a block and written to a block-chain, it cannot be changed and therefore is immutable.
Merkle Tree/Hash Tree	In cryptography and computer science, a Merkle or hash tree is a tree in which every leaf node is labelled with the hash of a data block, and every non-leaf node is labelled with the cryptographic hash of the labels of its child nodes.
Mining	In a public block-chain, the process of verifying a transaction and writing it to the block-chain for which the successful miner is rewarded in the cryptocurrency of the block-chain.
Node	A computer which holds a copy of the block-chain ledger.
Non-Fungible	The property an item of not being exchangeable with other like items. For example, USD and Euros are fungible. For example, a Stratovarius violin is non-fungible because the value of it cannot be expressed in a number of other violins.
Public/Private Key	A public key is a unique string of characters derived from a private key which is used to encrypt a message or data. The private key is used to decrypt the message or data.
Peer-to-Peer (P2P)	A direct connection between two participants in a system - can be computer to computer or person to person.
Smart Contract	Self-executing computer code deployed on a blockchain to perform a function, often, but not always, the exchange of value between a buyer and a seller.
Stablecoin	A cryptocurrency which is underwritten by an asset or assets (e.g., fiat currency, commodities, etc.) designed to minimize the volatility of the price of the coin/token.
Transparency	Primary property of public block-chains whereby any participant in a system or transaction, can view transactions on the block-chain.
Wallet	Digital file that holds coins & tokens held by the owner. The wallet also has a blockchain address to which transactions can be sent.
Wallet (Cold)	A wallet disconnected from the internet.
Wallet (Hot)	A wallet connected to the Internet.

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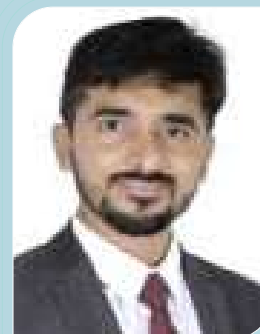


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