

Taxation of Virtual Digital Assets – Ramification for Non-Resident

Crypto assets have been in existence since 2009 and across the globe¹, rules and regulations are being introduced to regulate and tax transactions in cryptocurrencies. The Finance Bill, 2022 proposes to introduce a regime for taxation of income arising from transfer of “virtual digital assets” (VDA). The scope of VDA as per the proposed definition is wider than the typical cryptocurrencies. The rationale of introducing the tax law seems to be the popularity gained by such assets and also the trading volume of the assets in recent times. Read on...



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This article analyses the implications of the proposed tax regime for taxation of VDAs from the perspective of non-residents.

Proposed Taxation Regime

The finance minister in the Budget speech on 1st February 2022 stated that 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.

The following proposed sections have been introduced to tax the transactions of virtual digital assets:

Section 2(47A)

Proposed section 2(47A) contains a very wide definition of term “virtual digital assets”.

“(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,



¹ OECD report suggests that countries such as Australia, France, Chile, Czech Republic, Luxembourg, Nigeria, Spain, Sweden Switzerland, Argentina,* Brazil, Croatia, Denmark, Israel, Japan, Slovak Republic, South Africa and the United Kingdom have introduced guidance on taxation of virtual currencies.

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by notification in the Official Gazette specify:

Provided that the Central Government may, by notification in the Official Gazette, exclude any digital asset from the definition of virtual digital asset subject to such conditions as may be specified therein.

Section 115BBH

This section provides that any income from transfer of any virtual digital asset shall be taxed at the rate of 30 per cent. No deduction in respect of any expenditure or allowance shall be allowed while computing such income except cost of acquisition. Further, loss from transfer of virtual digital asset cannot be set off against any other income.

Section 194S

In order to capture the transaction details, it is also proposed to provide for Tax Deduction at Source (TDS) on payment made in relation to transfer of virtual digital asset at the rate of 1 per cent of such consideration above a monetary threshold.

Section 56(2)(x)

Besides the above new sections, an amendment has been proposed in section 56(2)(x) to tax the transactions of gift of virtual digital asset in the hands of the recipient. The definition of the term "property" has been amended to include VDA.

1. Taxation of Non-resident

a. Basis of Taxation

India follows residence basis of taxation. Residents are taxed on global income and non-residents are taxed on India sourced income. The

following income of non-residents are taxed in India:

- Income received or deemed to be received in India;
- Income accrues or is deemed to accrue in India

If the income from transfer of VDA is received in India or accrues or deemed to accrue in India, then the income earned by non-resident from transfer of VDA shall be chargeable to tax in India.

Existence of the situs of the asset is in India would be important in determining whether the income from transfer of VDA can be said to be accruing in India or deemed to be accruing in India.

Identification of situs of an intangible asset like VDA becomes difficult. VDA is comparable to an intangible asset and some guidance can be availed from judicial precedents related to intangible assets. The Delhi High Court has in the case of *CUB Pty Ltd. v. Union of India*² held that location of an intangible asset (trademark) owned by a non-resident is not in India. The High Court relied on the well accepted principle of '*mobilier sequuntur personam*' according to which the situs of the owner of an intangible asset would be the closest approximation of the situs of an intangible asset. Reference may also be made to a CBDT Circular³ issued in the context of wealth tax, which deals with location of assets.

Based on the above, the NR may want to argue that the



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situs of the VDA owned by him is outside India. However, when the VDA transactions happen on an exchange in India or the VDAs are issued by an Indian issuer, it will be difficult to claim that income does not accrue or arise in India. Further, the income would also be taxable in India if the income is received in India.

b. Capital asset or stock in trade

The taxability in the hands of the non-resident will also depend on whether the VDA is held as a stock-in-trade or capital asset. Characterization of income from sale of shares has historically resulted in several disputes and the guidance contained in judicial precedents and CBDT circulars can be applied to some extent to VDAs by analogy as the proposed regime does not categorically classify VDA as a capital asset.

Consequently, it may not be relevant to get into characterization of VDA as capital asset or stock in

² [2016] 71 taxmann.com 315 (Delhi)

³ Circular No. 3 (WT) of 1957, dated 28-9-1957



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trade for the purposes of the provisions of section 115BBH. However, the same may be relevant for the purposes of applying the provisions of the applicable tax treaty.

The subsequent para discusses the aspects of taxation on transfer of VDA held as a capital asset and stock in trade.

2. Stock in trade

a. *Taxation under the domestic law*

Business is defined in section 2(13) of the Act as “business” which includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture.

A trader would be one who regularly (frequency) buys and sells VDA and seeks to make profits out of short-term market fluctuations (profitability). In such a scenario, holding of VDA may be considered as stock in trade. The gains realized by the trader may be taxed as business income.

Under the Act, the non-resident shall be liable to tax under section 115BBH.

b. *Taxation under the tax treaty*

By virtue of the provisions of section 90(2), the non-resident has an option of applying the provisions of the tax treaty, if the same are more beneficial.

Generally, Article 7 of the tax treaty deals with taxation of business profits. It provides that the profits of a non-resident carrying on business shall be taxable only in a resident State unless the non-resident carries on business in the other Contracting State through a permanent establishment (PE). If the non-resident carries on business in the other Contracting State, only profits attributable to the PE shall be taxable in the other Contracting India.

Thus, non-residents holding VDA as stock in trade shall be liable to tax in India if they have a PE in India and the profits from transfer of VDA is attributable to the PE in India. However, few treaties signed by India⁴ include Force of attraction (FOA) rule under Article 7 and applicability of this rule also needs to be considered.

3. Capital asset

a. *Taxation under the domestic law*

Section 2(14) of the Income-tax Act, 1961 (‘Act’) defines capital asset as property of any kind held by an assessee, whether or not connected with his business or profession.

b. *Taxation under the tax treaty*

If the VDA is held as a capital asset, the income

arising from transfer of such a VDA would be governed by the provisions of Article on Capital Gains of the tax treaty. Generally, the Article on capital gains specifically provide for taxability from alienation of:

- Immovable property;
- Movable property forming part of PE including gains from alienation of the PE;
- Ships and aircrafts operated in international traffic;
- Shares
- Any other property

It can be argued that the VDAs such as crypto currencies may not qualify as immovable property.

Similarly, if VDA constitutes movable property forming part of the PE of the non-resident in India, the alienation of such VDA would be taxable in India.

If the VDA does not qualify as any of the specified assets governed by the capital gains article, the taxability of income from transfer of VDA would be governed by the residuary clause⁵ which generally provides for taxation of the gains in the resident State of the alienator.



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⁴ E.g. Belarus, Canada, Slovak Republic, Denmark, Indonesia, Italy, Mongolia, New Zealand, Poland, Spain, USA.

⁵ Residuary clause of Capital Gains Article of treaties such as Singapore, Mauritius, Netherlands, Swiss Confederation, etc. provide for taxability of capital gains in the resident State.

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4. Income from other sources

If under the domestic law provisions, the income from transfer of VDA is taxed under the head 'income from other sources', it is likely that under the tax treaty also it would be taxed under the Article dealing with other income. Tax treaties signed by India adopting Other Income article from the UN Model provides for taxation of other income in the source state.

5. Tax deducted at source on income of non-resident

Proposed section 194S provides for obligation of 'any person' responsible for paying to a resident consideration on transfer of VDA to deduct tax at source @ 1% on such consideration. The said section does not deal with payment to non-residents.

Payments to non-residents on account of transfer of VDA would continue to be governed by the provisions of section 195.

If the income from transfer of VDA by non-residents is chargeable to tax in India, the withholding will have to be done as per the provisions of section 195. This would typically cover the following transactions:

- (i) Resident acquiring VDA from a non-resident.



If the VDA is held as a capital asset, the income arising from transfer of such a VDA would be governed by the provisions of Article on Capital Gains of the tax treaty.

- (ii) Non-resident acquiring VDA from another non-resident⁶

However, based on the discussion in paras 4 and 5 above, if the income of the non-resident is not chargeable to tax relying on the favourable tax treaty provisions, the purchaser can rely on the judicial precedents⁷ which have held that if the income of the non-resident is not chargeable to tax in India, there is no obligation to withhold any tax under section 195.

However, if the transaction of buy-sell of VDA is happening through an exchange, it will be practically difficult to comply with the TDS provisions for the reason that the buyer and the seller may not know each other. It will not be possible to comply with withholding provisions when the identity of the seller is not known to the buyer.

6. Obligation of a non-resident to deduct tax at source

a) Proposed section 194S

Section 194S casts an obligation on 'any person' to deduct tax at source @ 1% on the amount of consideration paid to a resident on transfer of VDA. The term 'any person' is wide enough to cover non-residents. Consequently, non-residents acquiring VDA from a resident, shall be liable to withhold tax under section 194S.

On the basis of the observation of the Supreme Court in the case of Vodafone International Holding B.V. v. UOI⁸, one may want to argue that when the non-resident does not have a presence in India, the TDS provisions cannot be applied relying on the principle of extraterritorial application of



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the domestic law. However, after the above Supreme Court ruling, Finance Act, 2012 amended the provisions of section 195 retrospectively, clarifying that withholding tax obligation on payment to a non-resident is applicable to non-residents whether or not such non-resident payer has any presence in India. This suggests the approach of not excluding non-resident from withholding obligations. However, when the transaction happens on an exchange, the identity of the recipient of consideration would not be known to the non-resident buyer and implementation of withholding could become impossible.

Conclusion

There are ambiguities in the proposed regime. As per the media reports, Central Board of Direct Taxes (CBDT) is expected to issue guidelines shortly to provide clarity on various aspects of taxation. The definition of VDA itself will have to be clarified. Further, issues such as applicability of TCS / TDS provisions also need to be clarified. Hence, taxpayers will have to wait and watch till the CBDT comes out with the guidelines.

⁶ Explanation 2 to section 195.

⁷ GE India Technology Centre Private Ltd v. CIT (2010) 327 ITR 456

⁸ [2012] 17 taxmann.com 202 (SC)