IMPACT ASSESSMENT OF 1% TDS ON VDAs

A REPORT BY **CHASE INDIA & INDUSLAW**

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Overview

A crypto asset is generally considered a digital asset that has been tokenized, which is the transfer of an object's value to a blockchain. The tokens can be fractionalized for broader distribution of ownership, much like dividing ownership of an asset into shares—but these shares are digital. At present, no legislation governs, regulates, or prohibits dealing in virtual digital assets (VDAs) in India.

The journey of VDAs in India has been eventful over the past few years, beginning with the judgement of the Hon'ble Supreme Court, inclusion of VDAs in India's tax regime, and the PMLA with ongoing concerns over UPI rails. Amid these highs and lows, India's G20 Presidency has brought a paradigm shift by paving the way for a global regulation of crypto assets. Since the beginning of G20, the regulation of VDAs has always been on a priority list of discussions by the authorities, with the International Monetary Fund (IMF) and Financial Stability Board (FSB) playing a crucial role in shaping the global approach.

During the G20, the government seemed more inclined towards including crypto and the underlying blockchain technology under regulation rather than an outright ban. The G20 discussions over the years resulted in the creation of the IMF-FSB Synthesis Paper, which outlines a roadmap to ensure effective, flexible, and coordinated implementation of the comprehensive policy framework for crypto assets. The comprehensive discourse on the regulatory approach towards crypto assets is one of the most significant outcomes of India's G20 presidency.

The New Delhi Leaders' Declaration as well as the Communiqué adopted by G20 Finance Ministers and Central Bank Governors in Marrakesh, Morocco have welcomed the Synthesis Paper and called on to adopt the proposed roadmap as a G20 Roadmap on Crypto Assets. The authorities called for swift and coordinated implementation of the G20 Roadmap, including implementation of policy frameworks; outreach beyond G20 jurisdictions; global coordination, cooperation and information sharing; and addressing data gaps. Meanwhile, the IMF and FSB have been asked to provide regular and structured updates on the progress of the implementation of the G20 Roadmap on Crypto Assets. The ongoing work and global implementation of FATF standards on crypto assets have also been mentioned.

"The G20 has formally adopted the crypto regulation roadmap, which outlines a framework for addressing the associated risks and opportunities of crypto assets. There is yet to be a timeline for countries to implement the roadmap",

Nirmala Sitharaman,
Union Finance Minister,
Government of India.

"India's policy decisions would be significantly influenced by the risk assessment framework established by the G20. The Synthesis Report recommendations would be studied, and in due course, decisions would be made tailor made for India's unique socio-economic fabric",

Ajay Seth,
Secretary, Department of
Economic Affairs.

"It should be clear that we do not think of cryptocurrency as a currency, but as an asset. In which case it should be taxed like any other asset, which is what we have done, and I am in favour of it,"

Sanjeev Sanyal,
Member, Economic Advisory
Council.

Key Aspects of VDA Governance in India

Definition of Virtual Digital Assets	Often interchangeably used for cryptos, "virtual digital asset" by definition was inserted via the Finance Act 2022,[1] to be included in Clause 47A under Section 2 of the Income Tax Act[2], 1961. VDAs thus according to the official record now stated as: • 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. • A non-fungible token or any other token of similar nature, by whatever name called. • Any other digital asset, as the Central Government may, by notification in the Official Gazette specify.
Taxation Laws	Taxation at the rate of 30% on income from trading of all kinds of VDAs was introduced in February 2022, via the Union Budget. This new provision comes into effect from April 1, 2022. 1% TDS on payments was also introduced for the transfer of digital assets in order to capture the transaction details. However, it was clarified by the government immediately after, that introducing taxes does not mean that industry has been given a legal or regulatory nod.

The paper highlights how the announcement and subsequent implementation of TDS norms which were introduced for putting in place a tax structure and revenue stream as well as to remove "difficulty" of investors has impacted the ecosystem stakeholders. It focuses on the shortcomings of the investors' shift to grey market as a result of non-compliance of some trading platforms-cum-exchanges. Further, the paper suggests certain recommendations that may be taken up by the authorities to address the issue.

[1]https://www.indiabudget.gov.in/doc/Finance_Bill.pdf
[2]https://incometaxindia.gov.in/pages/acts/income-tax-act.aspx

VDAs Sector and its Prospects in India

VDAs in India has gone a long way in a short time. VDA exchanges were virtually non-existent in India five years ago. Presently, India's VDA landscape is outshining its global counterparts, and there are numerous factors behind the industry's remarkable success. The sector has a massive potential in terms of contribution to economy, generating employment, attracting huge FDIs, but it needs a well-defined regulatory framework to unlock its growth. Moreover, according to a report published by CrossTower and US-India Strategic Partnership Forum, embracing and fostering VDAs in India would grow India's GDP at a healthy 43.1% CAGR from $5.1 billion in 2021 to $261.8 billion over an 11-year period, resulting in a $1.1 trillion contribution to India's GDP. The bulk of this $1.1 trillion in economic growth for India over these 11 years would be derived from ancillary VDA-related businesses that are yet to be invented [8].

Approximately 15-20 million investors are holding more than US$5.3 billion in VDAs, according to a report by Reuters citing industry estimates.

Over 7% of India's population owns some category of VDAs making it the highest number of crypto owners from one country across the globe.

VDA sector has created about 50,000 employment opportunities in India and this figure is anticipated to reach over 8,00,000 by 2030.

Estimates suggest that the current size of the VDA market in India is above US$15 billion.

Indian VDA exchange market is expected to expand at a CAGR of 30% in between FY'22 and FY'27on the basis of revenue generated.

Estimates suggest that the market capitalisation of the VDA industry could reach US$1 trillion by 2025 with a progressive policy framework

India's VDA landscape is outshining its global counterparts, as it has the highest adoption rate in the world.

India's VDA market is poised to gain significant traction from increasing women participation.

VDAs have garnered particular traction among India's millennial population.

Sources:

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Understanding 1% TDS on VDAs

In the latest development, the Government vis-à-vis Finance Act 2022 introduced Tax Deducted at Source or TDS for virtual digital assets. This introduced a new section 194S in the Income-tax Act, 1961, which came into effect from 1st July 2022. It mentions levying a 1% TDS on any consideration paid for the transfer of VDAs. In other words, when you sell crypto, the exchange facilitating the transaction will have to deduct and withhold 1% of the transaction value as TDS, which is then paid to the Government.

Deliberating more on the announcement, the Central Board of Direct Taxes (CBDT) issued a Circular (No. 13 of 2022)[3] on June 22, 2022, with detailed guidelines on the mechanism of levying this TDS and intending to provide some clarity to taxpayers on the tax withholding provisions on crypto assets.

As per the new guidelines, the buyer of a VDA is required to deduct 1% of the amount paid to the seller (an Indian resident) as TDS. The tax is required to be deducted at the time of credit of the amount or at the time of payment to the resident individual. “Thus, in a peer to peer (i.e. direct buyer to seller) transaction, the buyer (i.e. person paying the consideration) is required to deduct tax under section 194S of the Act.” The liability to deduct tax under Section 194S (of the Income Tax Act) applies only when the value or aggregate value of the consideration for transfer of VDA exceeds INR 50,000 during the financial year in case of consideration being paid by the specified person, and INR 10,000 in other cases. (TDS under this new section shall be on the “net" consideration after excluding GST/charges levied by the deductor for rendering service.)

The Circular has taken cognizance of the fact that in a transaction that takes place on an exchange, there is a possibility of TDS requirement for VDA to be triggered at multiple stages and/or with considerable nuances. Few noteworthy points on the same:

- Where the VDA is not owned by the exchange but the payment to the seller is made by the exchange directly, tax may be deducted only by the exchange.
- Where the payment to the seller by the exchange is through a broker, both the exchange and the broker shall deduct tax unless it has been agreed between the exchange and the broker that the broker shall deduct tax on such credit/payment in which case, the broker alone may deduct tax.
- Where the VDA is owned by the exchange, the primary responsibility to deduct tax remains with the buyer or his broker.

[3]https://incometaxindia.gov.in/communications/circular/circular-no-13-2022.pdf

Virtual Digital Assets Under Prevention of Money Laundering Act

PMLA Notification and its Nuances

The Ministry of Finance issued a gazette notification on March 7, 2023, bringing businesses involved in providing services related to VDAs under the ambit of the Prevention of Money Laundering Act (PMLA). The Ministry explained that providing services related to trading in VDA-fiat, VDA-VDA, or storing and managing VDA will be dealt with under the PMLA.

This can also be seen as a step further by the government to implement FATF Travel Rule, which targets the anonymity of VDA transactions and mandates that VASPs obtain, hold, and exchange information about the originators and beneficiaries of virtual asset transfers. This enables financial institutions and VASPs to conduct sanctions screenings and detect suspicious transactions so that any necessary measures can be taken to prevent AML/CFT. In June 2022, FAFT recommended nations to fast-track checks on VDA users' identities, and also highlighted that only 11 of 98 surveyed jurisdictions had enforced and supervised the travel rule.

The notification read, "Participation in and provision of financial services related to an issuer's offer and sale of a virtual digital asset...For the purposes of this notification 'virtual digital asset' shall have the same meaning assigned to it in Clause (47A) of Section 2 of the Income-Tax Act, 1961 (43 of 1961)." Furthermore, the notification also said that VDA shall have the same meaning as given to it in clause (47A) of section 2 of the Income Tax Act of 1961.

Some of the key compliance aspects of the notification include:

- Report suspicious activity to the Financial Intelligence Unit India (FIU-IND).
- Follow KYC, anti-money laundering regulations and due diligence.
- Client verification, i.e., KYC, record-keeping and reporting.
- Verify and maintain accounts of individuals and transactions.
- Verification of source of funds, ownership and financial positions.
- Empowers government to access information stored by crypto exchanges.

The PMLA notification has been received positively by the VDA sector as it is being seen as another step towards strengthening/regulating the emerging Indian digital assets ecosystem. At the same time, it would help in building trust by improving transparency and providing greater oversight. This would go a long way in mitigating the risks such as money laundering and terrorist financing associated with the sector as well as providing a conducive regulatory environment to further flourish innovation and investment.

Few of the leading crypto exchanges in India were already voluntarily conducting several compliance activities including KYC and validating all documents from customers. However, this has now become a compulsion rather than a choice which would help in eliminating bad actors from the ecosystem and prevent its misuse.

Things to Consider Now (By Investors)

As PMLA notification has come into effect, the crypto exchanges can work in sync with the government authorities on red-flagging problematic transactions. Therefore, it is now the responsibility of the investors to invest safely and declare taxes.

- The most important thing for the investors to remain cautious is to choose a tax and PMLA compliant VDA exchange for transactions. Since the sector is largely unregulated, there are several non-compliant exchanges which are not working as per the Indian laws and regulations despite coming under the legal purview. This can be detrimental for the investors and also undermine the government's efforts towards consumer protection and empowerment.
- The other aspect to be considered by investors is to keep a record of all their transactions in order to avoid any sort of financial wrongdoing. It is important for the consumers to understand that if a person is not disclosing the monetary value of the transaction to the government, and the receiver is not disclosing it as an income, both parties can be held liable under PMLA.
- Also, investors should properly declare their gains in VDAs as the government now will have a mechanism to track all trades, even retrospectively as well. Although many services and platforms can help in generating consolidated tax statements, the onus is still on the investors to file accurate information.

Taxation of Crypto Assets

Regulators worldwide have been dealing with the crucial aspect of leveraging innovation related to crypto assets, while at the same time securing financial stability and investor protection. For tax authorities, the task is to encompass developments in the use of crypto assets into a well-functioning tax system. It is important to consider that whether crypto withers or blossoms, the tax system still needs to deal with it.

The G20 leaders have unanimously agreed to provide greater insights to tax authorities into transactions of crypto assets. This can be seen as a step forward in a positive direction and is an indication of global cooperation on crypto. The authorities discussed strategies and ways forward in international taxation with regard to the implementation of measures. Both New Delhi Leaders' Declaration as well as IMF-FSB Synthesis Paper have specifically outlined a few aspects in context to global taxation of crypto assets:

New Delhi Leaders' Declaration

- The G20 Leaders called for the swift implementation of the Crypto-Asset Reporting Framework (CARF) and amendments to the 'Common Reporting Standard' (CRS).
- CARF, developed in light of the rapid growth of the crypto asset market and pursuant to a mandate from the G20, provides for the reporting of tax information on transactions in crypto assets in a standardized manner, with a view to automatically exchanging such information with the jurisdictions of residence of taxpayers on an annual basis.
- So, now crypto transactions undertaken by Indians on foreign-domiciled crypto exchanges will also come under the purview of automatic exchange of information protocol under CARF, and as such it will no longer be possible to hide or conceal such crypto transactions.
- Similarly, under the amended CRS, requiring more tax transparency with respect to financial accounts held abroad, it would become next to impossible for Indians not to disclose their foreign bank accounts and assets holdings abroad to the tax authorities.
- The Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum) has been tasked to identify an appropriate and coordinated timeline to commence exchanges by relevant jurisdictions, noting the aspiration of a significant number of these jurisdictions to start CARF exchanges by 2027.
- The Crypto Asset Reporting Framework (CARF) or template is being developed to make sure that such non-financial assets are not used by tax evaders to conceal their unaccounted wealth.
- The G20 leaders reaffirmed their commitment to continue cooperation towards a globally fair, sustainable and modern international tax system appropriate to the needs of the 21st century.

IMF-FSB Synthesis Paper

- A comprehensive policy and regulatory response for crypto assets is necessary to address the risks of crypto assets to macroeconomic and financial stability. To address macroeconomic risks, jurisdictions should safeguard monetary sovereignty and strengthen monetary policy frameworks, guard against excessive capital flow volatility and adopt unambiguous tax treatment of crypto assets. Comprehensive regulatory and supervisory oversight of crypto assets can help to address financial stability and financial integrity risks while supporting macroeconomic policies.

- The spread of crypto assets can increase fiscal risks. New fiscal risks can arise from the financial sector's exposure to the crypto-asset ecosystem, lack of clarity of tax regimes, and the cross-border nature of crypto assets. In turn, crypto assets can affect tax revenue collection and compliance, even when not adopted as legal tender. The implementation of the OECD's Crypto-asset Reporting Framework across jurisdictions will support tax authorities' efforts to collect revenues.
- Tax policies should ensure the unambiguous tax treatment of crypto assets, and tax administrations should strengthen compliance efforts. Legal provisions should clearly reflect policy decisions on the tax treatment of crypto assets, including income/wealth and value-added taxes. Tax administrations should leverage third-party information, especially when intermediaries such as crypto asset trading platforms, broker-dealers, and other intermediaries are involved, to enhance tax compliance.
- Collaboration on cross-border information sharing and financial regulation is crucial for effective tax compliance. The adoption of frameworks like the Crypto-asset Reporting Framework (CARF) proposed by the OECD can be beneficial. Improving institutional capacity, investing in specialised data infrastructure and analytics and prioritising training for tax administration staff are essential to support risk analysis and tax audits related to crypto asset operations.
- Mitigate problems associated with under-assessing or under-collecting tax on transactions involving crypto assets. This requires a transparent and predictable tax law framework, coupled with international cooperation. While tax laws generally apply to crypto assets based on their legal characterisation, adjustments may be needed to provide clarity and certainty and to achieve a country's specific policy objectives. Tax administrations should complement existing frameworks with timely and comprehensive guidance to taxpayers to promote transparency and predictability of treatment. Additionally, countries should clarify payment and reporting obligations, including by crypto asset service providers.

Current State of Crypto Adoption in India

Blockchain analysis firm Chainalysis recently released the fourth edition of its 2023 Global Crypto Adoption Index. The index combined on-chain data and real-world data to measure which countries are leading the world in grassroots crypto adoption. The index identified countries where the most people are putting the greatest share of their wealth into crypto. Grassroots crypto adoption isn't about which countries have the highest raw transaction volumes, Instead, it's the countries where average, everyday people are embracing crypto the most.

The index ranked 154 countries across five sub-indexes, which have been identified on the basis of countries' usage of different types of crypto services. These include on-chain crypto value and retail value received at both centralized exchanges and DeFi protocols, as well as peer-to-peer exchange trade volume.

The top 20 countries and key data points of the 2023 Global Crypto Adoption Index are mentioned below:

Country	Region	Overall index ranking	Centralized service value received ranking	Retail centralized service value received ranking	P2P exchange trade volume ranking	DeFi value received ranking	Retail DeFi value received ranking
India	Central & Southern Asia and Oceania	1	1	1	5	1	1
Nigeria	Sub-Saharan Africa	2	3	2	1	4	4
Vietnam	Central & Southern Asia and Oceania	3	4	4	2	3	3
United States	North America	4	2	8	12	2	2
Ukraine	Eastern Europe	5	5	3	11	10	10
Philippines	Central & Southern Asia and Oceania	6	6	6	19	7	7
Indonesia	Central & Southern Asia and Oceania	7	13	13	14	5	5
Pakistan	Central & Southern Asia and Oceania	8	7	7	9	20	20
Brazil	Latin America	9	9	11	15	11	11
Thailand	Central & Southern Asia and Oceania	10	8	15	44	6	6
China	Eastern Asia	11	10	5	13	23	23
Turkey	Middle East & North Africa	12	11	9	35	12	12
Russia	Eastern Europe	13	12	10	36	9	9
United Kingdom	Central, Northern, & Western Europe	14	15	20	38	8	8
Argentina	Latin America	15	14	12	29	19	19
Mexico	Latin America	16	17	18	30	16	16
Bangladesh	Central & Southern Asia and Oceania	17	18	19	33	22	22
Japan	Eastern Asia	18	22	21	49	18	18
Canada	North America	19	25	23	62	14	14
Morocco	Middle East & North Africa	20	27	25	21	26	26

Source: Chainalysis Global Crypto Adoption Index

India leads the world in "grassroots crypto adoption" which goes beyond raw transaction volumes. The country secured the first position in four critical parameters - Centralized Service Value, Retail Centralized Service Value, DeFi Value and Retail DeFi Value.

India has also become the second-largest crypto market in the world by raw estimated transaction volume, beating out several wealthier nations, despite challenging regulations and stringent taxation.

Low-income countries including India, identified under the World Bank's classification of nations by wealth, saw a dramatic uptick in crypto adoption following a slump in late 2022, spurred by the collapse of the FTX.

Central and South Asia and the wider Oceania regions dominate the top of its index, with six of the top 10 countries in this part of the world.

1% TDS on Crypto Transaction – Still A Pain Point for Users

VDA ecosystem players have termed the global coordination during the recently concluded G20 under India's presidency a remarkable milestone and termed the Crypto-Asset Reporting Framework (CARF) proposed by the IMF-FSB synthesis paper as a positive development. However, the existing 1% TDS on every crypto transaction is still an area of concern for the users.

It was understood that the underlying objective of the TDS was to track crypto transactions, but on the contrary, it is becoming a pain point for the entire sector, leading to a severe decline in the development of the ecosystem. This has led to Indians shifting to foreign jurisdiction based out of tax havens to avoid the 1% TDS.

It is important to note that the anti-money laundering provisions (PMLA) recently imposed by the government on VDAs are serving the purpose of tracking suspicious transactions, resulting in greater oversight by the government. With this development, the imposition of a 1% TDS is having a negative impact as it is resulting in the shifting of crypto traders from local exchanges to platforms in foreign jurisdictions and the grey market, thus impacting the overall objective of tracing illegal transactions. Additionally, one also has to look at the cost and effort of tracking such suspicious transactions and if the tax imposition will offset the cost of investigations. The move of traders/investors to foreign jurisdictions will increase the cost of such investigations also.

In a nutshell, it is imperative for the regulatory authorities to seriously look into the situation and arrest the shifting of funds to offshore exchanges. The situation can be effectively addressed by creating a level playing field and imposing a lower TDS, preferably between the range of 0.1-0.5%. This would serve the government's purpose of tracking illegal transactions, money laundering and tax evasion without hurting the growth of the industry which is at a nascent stage.

Impact of TDS on Stakeholders

The impact of the 1% TDS rule on the concerned stakeholders has been detailed in this section, with a current overview and further forecast of non-adherence of grey market exchanges to the rule of law.

Industry

Impact on Business Operations

Once the crypto and VDA tax law came into force, there was a substantive decline in the volume of transactions on the platforms as stated by industry analysts and estimates.[4] These will further lead to several discrepancies in the industry ecosystem as owing to reduction in trade and subsequent deceleration of profit margin, resulting in several small scale exchanges to potentially shut down and the big (by market cap) exchanges will have to adopt the reduced profitability in the form of pivoting of business.

- Estimates report that daily volumes at key India-based exchanges reduced by 90 per cent just after the 1% tax on crypto transactions took effect.[5]
- In fact, a major crypto exchange of India saw trading volumes plummet by around 70 per cent, falling from $14.13 million on June 30, 2022 (before the TDS enforcement) to $4.14 million on July 4, 2022, according to Coingecko market tracker data.[6]
- As another example of a crypto exchange platform, downloads shrank to 163,000 in August from 2.2 million in January.[7]
- Trading volumes on some other major Indian crypto exchanges also plunged about 83%, 70%, 76%, and over 18%, respectively, in the week of TDS coming into force.[8]

Concerns for the industry have risen in the form of credible exchanges being called out for increasing global crypto scams and frauds taking place. This is 'complemented' by the fact that trading in crypto assets have not found a regulatory and policy standing in themselves and have no guidelines to cater to in such situations for a sustainable business practice and legitimacy. **This has put a significant setback to the Ease of Doing Business criterion for crypto startups in the country and further derailing the emerging financial ecosystem.**

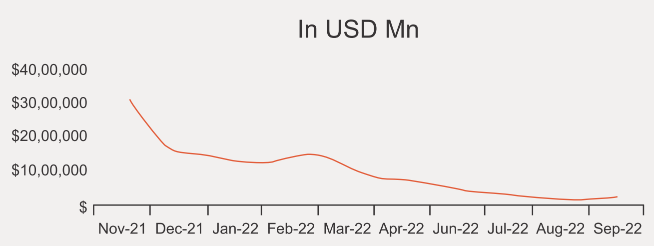

Figure 1: Trading volumes of major tax compliant Indian exchanges[9] (Graph shows downfall in volume post TDS implementation)

- Figure 1 highlights the reduction in trade volume of major tax compliant Indian exchanges before and after the TDS on VDA rule coming into effect from July 1, 2022.
- While pre-June 2022 trade volumes have been above $10,00,000; the figures post July 2022 steeped below $50,000 in average.
- The downward curve can also be correlated with the TDS announcement on Feb 2022, where post that, the exponential deceleration actually triggered.

[4] https://www.businesstoday.in/crypto/story/trading-volume-of-indian-crypto-exchanges-decline-after-application-of-1-tds-340718-2022-07-07
[5] https://www.livemint.com/market/cryptocurrency/crypto-traders-switch-to-foreign-exchanges-like-binance-to-escape-taxes-11663113422715.html
[6] https://indianexpress.com/article/technology/crypto/1-per-cent-tds-not-done-crypto-traders-disappear-from-exchanges-after-july-1-8009940/
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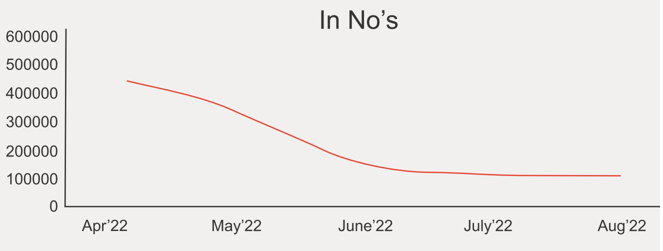

Figure 2: Apps installed for major tax compliant Indian exchanges[10]
(Graph shows reduced installations post TDS announcement and implementation)

- Figure 2 on the left indicates the slow installation rate of major Indian exchanges around the time when TDS rule started capturing attention.
- Post June 2022 and just before the July implementation, the download rate decelerated and hit a flat line for the next two months.
- From mid-April 2022 to June 2022, the downloads decreased from 4 lakhs to a stagnant 1 lakh and below in average.

Shift of Investors to Non-Tax Compliant Exchanges

The perceived rampant taxation regime that the traders have to undergo for any VDA trade in India have made them shift to crypto exchanges that work in the grey[11] leaving the tax compliant exchanges in a state of limbo. The monthly downloads of one of world's leading crypto exchange firm saw a jump to 429,000 in August in India, the highest in 2022 till then, and almost triple that of one of its (major) Indian counterpart, basis the data from market intelligence firm Sensor Tower.[12] This shift can be correlated to the non-adherence of such crypto exchanges to the TDS norms. The tax rules imply that the exchanges levy this 1% TDS on transactions and submit the same to the tax authorities, on behalf of the user. Crypto exchanges apply this tax when a user places an order, thus reducing their net gains, to avoid slippage ('Slippage' is the difference in the expected price of an order and the price when it is actually executed).

Many exchanges, however, have not been following the said rules despite coming under the legal purview and mandate of conducting business under other Indian laws and regulations. While users transacting crypto assets from wallets to global exchanges over blockchain incur a one-time transaction fee called a *Gas Fee*,[13] many views this as a comparatively better option than paying TDS every time when they execute a trade. This is in-principle against the clarifications issued by the Central Board of Direct Taxes (CBDT) via the Circular No. 13 on June 22, 2022, wherein exchanges (naturally assumed both foreign and domestic) have to levy the 1% TDS on transactions. Many exchanges have been found to exempt this in their business practice with an unauthorized discretion. This loophole has thus led to a systemic 'grey market' scenario of such exchanges-cum-companies from the fence of taxation.[14] This has also substantiated into other issues for the sector as LEAs' increased inspection towards the industry players has created a negative perception on cryptos, and thereby taking its toll on players who wish to conduct business via 'fair' and lawful means. Investors or the common public will tend to use such financial products not just when it is giving the returns but also when it is perceived well in its outlook[15] – the entire industry thus suffers because of the intentional glitches of the few. **The shift of investors to non-tax complying exchanges will be thus detrimental to the law-abiding ones.**

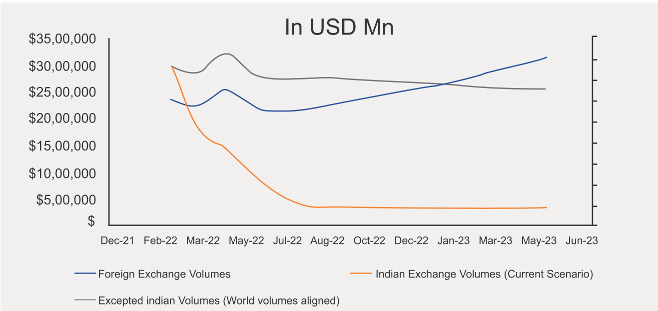

Figure 3: Volume comparison of major Indian tax compliant exchanges with foreign exchanges; with expected/forecasted volume[16]

- Figure 3 shows that while the major tax complaint Indian exchanges registered a decline in its trade volume around TDS rule, the foreign exchanges' trade volume actually increased from $20,00,000 in May 2022 to $25,00,000 post Aug 2022 in average.
- With the same upward slope, it is expected to reach more than $30,00,000 in trade volume by early 2023, while the Indian tax compliant counterpart will be at a significantly lower volume of $5,00,000 by that time.

[10]https://www.bloomberg.com/news/articles/2022-09-13/crypto-traders-flee-indian-exchanges-for-binance-to-escape-taxes?leadSource=uverify%20wall
[11]https://www.livemint.com/market/cryptocurrency/crypto-traders-switch-to-foreign-exchanges-like-binance-to-escape-taxes-11663113422715.html
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[16]www.nomics.com and https://www.imarcgroup.com/cryptocurrency-market#%3A~%3Atext%3DMarket%20Overview%3A%26text%3DLooking%20forward%2C%20IMARC%20Group%20expects%2C58.4%25%20during%202022%2D2027

Innovation and Crypto Brain-Drain

The brain drain has arisen because of two parallel instances. Firstly, the overall business viability and market interest have decreased leading to companies employing less professionals and a talented workforce. This pool of talent is thus starting to shift elsewhere. Secondly, the decreasing space for conducting a sustainable business has pushed crypto and VDA startups to relocate their companies outside of India altogether to be in the competition and race with these other (grey) entities,[17] subsequently reducing the scope of innovation in eminent emerging technologies like blockchain, Web 3, metaverse and decentralized finance (DeFi) in India. About 300 Web 3 Indian startups have already moved their operations outside India as per a NASSCOM report.[18] Both the instances are further aggravated with the growing option of companies (competing and) allowing their employees to work from home and avail flexible remote working options, that is, 'work from anywhere'.

While the world is looking to explore more opportunities to expand on the different use cases of crypto and VDAs, India may potentially face the brunt if these exchanges are allowed to follow their discriminatory practice of non-adherence and non-compliance to the taxation regime. While the current TDS norms can still be supported and favored by the industry, the voluntary exemption factor can have long-lasting impacts. **A brain drain of this sort may eventually also impact the progress of science or STEM proliferation in India, where the young technology entrepreneurs of tomorrow who need to be nurtured under a favorable ecosystem will have potential dead-ends in their learnings and growth.**

Government

Lack of Stringent Implementation overshadowing the Objective

The June 2022 Circular by the Central Board of Direct Taxes (CBDT) does not clarify whether the TDS tax process applies specifically to Indian exchanges. It mentions at various stages only "exchanges" and hence naturally all VDA-based exchanges should have fallen under the ambit of this law for tax deduction of Indian investors. An oversight has been a cause of worry not just for the industry (as aforementioned) but for the government as well with the process deviating away from the government's financial ethos of lawful taxation of the transactions. This also creates the possibility where certain of these crypto players working in grey can take further undue advantage bypassing the system and where stringent implementation and monitoring wasn't checked prior. Going into the specific examples of what may arise here, lack of such oversight may lead to exchanges being used as a breeding ground for financial crimes like terror financing, money laundering and for illegal and other criminal activities, as there would be no accountability to any player, and with no backtracking of tax paid - will be an attractive route for offenders. **Lack of stringent implementation is thus overshadowing the government's intent of a lawful tax regime.**

[17] https://cointelegraph.com/news/brain-drain-india-s-crypto-tax-forces-budding-crypto-projects-to-move
[18] https://timesofindia.indiatimes.com/business/startups/trend-tracking/but-brilliant-indian-engrs-are-moving-to-estonia-puerto-rico-dubai/articleshow/94953813.cms

Additional Burden of Authenticity of Exchanges

While many of VDA/crypto exchanges do perform KYC (know-your-customer) checks before allowing trading,[27] many of them still have an arbitrary or a significantly non-existence process of verifying the traders in their platforms. This has added to the burden of the government, as in case of any frauds or defaulting in practice, it will be even more difficult to decipher problems and find solutions basis the already tax incompliance by these exchanges. This free lease can result in more of such issues of KYC flouting amongst other concerns. **If the intermediary ecosystem who do follow the tax regime disappears, the crypto trades will move to a peer-to-peer mode or other modes making it difficult to track for the government and the regulators.**

Investors/Consumers

Scams and Frauds

Investors who are trading through these certain 'grey' exchanges owing to the lack of TDS oversight are now more prone to scams and frauds that would take place internationally. Since there is no adequate mechanism of checks and balances in the ecosystem here, investors are at risk of losing millions. According to a report by an Indian cyber security firm, investors in India have lost as much as INR 1,000 crore through fake crypto exchanges that have spread through social media portals[19]. The aim of introducing the TDS rules for the investors was to reduce the 'difficulty' quotient for the VDA investors on having taxable legitimacy. Tax oversight tends to counter that.

Moreover, with the increasing efforts by the government towards investor protection and generally empowering the consumers, the TDS non-compliance becomes a pertinent issue which is undermining the government's and industry's collective efforts of consumer's financial safety. **TDS withholding thus becomes a cross-ministerial concern and not just an oversight to be resolved by the tax authorities.**

Legal Concerns

As per section 195 of the Income Tax Act, tax is required to be deducted for any sum which is taxable under the Income Tax Act. A penalty of an amount equal to tax not deducted or paid could be imposed under section 271C of the Income Tax Act.[20] Investors can fall into these loops of legal and regulatory strains if the CBDT Directions are not duly followed by every stakeholder involved. Thus, **these intricacies with legal implications can come into the picture for the investors if the tax rule on exchanges isn't monitored.**

[19]https://www.techcircle.in/2022/08/22/supply-gap-persists-despite-higher-salaries-for-security-pros
[20]https://www.livemint.com/news/india/indian-investors-lose-rs-1-000-crore-in-fake-crypto-exchanges-report-11655801455169.html

Recommendations

The following recommendations can be considered to monitor exchanges' role and compliance with the TDS norms. The action of not just government but also the participation of industry, that is, rule abiding exchanges is a prerequisite in the process.

Recommendations	Details
Reconsider 1% TDS on Crypto Trade	The existing 1% TDS on VDA trade, combined with the absence of comprehensive regulations, is causing a flight of capital and users to platforms in foreign jurisdictions and the grey market. To address this issue, India should incentivize users to stay within the ambit of national jurisdiction by reconsidering the TDS rate. The purpose of the TDS is to establish a trail of crypto transactions, and the same can be achieved by a lower TDS rate. A nominal TDS rate would also support tracking and tracing of transactions, thus aiding in tax collections if Indian investors continued to trade from Indian KYC enabled platforms. Also, the PMLA notification imposed by the government can be seen as an effective step to track the transactions which can help address one of the key concerns of money laundering and terror financing. One of the major purposes of the TDS was to establish a trail of crypto transactions in order to support tracking and tracing of illegal transactions. This objective can now be effectively achieved through the PMLA notification. On the flip side, the higher TDS has resulted in shifting of crypto traders from local exchanges to platforms in foreign jurisdictions and the grey market, thus impacting the goals of tracing illegal transactions and establishing extant policy architecture. To enable a progressive taxation regime, it is strongly recommended that India should actively consider a nominal TDS rate in the range between 0.01-0.05% to support tracking and tracing of transactions, which would also aid in tax collections if Indian investors continued to trade from Indian KYC-enabled platforms. Therefore, it is important that India should incentivize users to stay within the ambit of domestic jurisdiction by reconsidering the TDS rate.
Benefit of Allowance of Setting off and Carry Forward of Losses incurred from Sale of VDA	Section 74 of the Income Tax Act, 1961 provides setting off and carry forward of losses incurred under the head 'Capital Gain' for a period of eight assessment years. It is recommended that the benefit under Section 74 of setting off and carry forward of losses should be extended to losses arising from VDAs as well.
Inclusion of Foreign Exchanges under Scope of TDS Mandate	Under the existing TDS framework, Indian VDA exchanges are the ones deducting and withholding the TDS under Section 194S of the Income Tax Act. While the intention of Section 194S is also to cover foreign exchanges and other buyers under the ambit of the TDS mandate, most such players are not deducting tax due to the absence of an explicit mention covering them under the legislation, and lack of India's tax laws applicability to such platforms. This has severely impacted the business of Indian VDA exchanges, while the foreign exchanges are still managing to offer competitive prices. Since VDAs are borderless and offer pseudo-anonymity, this makes it simple for Indian users to engage with VDAs on foreign platforms via P2P (Escrow) & other channels. It also allows such transactions to go unreported. It is recommended to specifically include foreign exchanges in the scope of the TDS mandate. This may be done either through an amendment to Section 194S or through the issuance of a clarification.

Reconsider Taxation at the Rate of 30% on Any Income from Transfer of VDA	This taxation provision under Section 115BBH (1) should be reconsidered and the income from transfer of VDAs should be treated at par with existing income sources. • From a consumer perspective, the income from transfer of VDAs should fall in the bracket of 'income from other sources' and accordingly, the relevant rate of tax should be applicable. • From a business perspective, the income from transfer of VDAs should fall in the bracket of 'business income' and accordingly, the relevant rate of tax should be applicable.
Self-Regulatory Organization (SRO)	From the standpoint of the industry stakeholders, crypto regulation is the need of the hour. While the government is seeking internal cooperation to regulate the crypto industry, an industry SRO can be created in the meantime to fill the regulatory gaps. This can be done by creating a mechanism for the recognition of a Self-Regulatory Organization (SRO). An SRO to be set up with the aim of protecting the customer and promoting ethical and professional standards amongst the exchanges. The SRO is thus expected to resolve disputes among its members internally through mutually accepted processes to ensure that members operate in a disciplined environment and even accept penal actions by the SRO. An ideal SRO would function beyond the narrow self-interests of the industry and address larger concerns, such as protecting customers, the development of the industry, and the ecosystem. The proposed SRO is to be comprised of relevant stakeholder groups. The creation of an SRO will be appropriate and encourage better compliance since there is a constant shift in the crypto sector. As the industry is forced to think in terms of developing systems that conform to best international practices, it would enhance global competitiveness as well. The SRO will require a group of stakeholders across sectors, and at least one third of members on the Board of Directors should be independent and not associated with member organizations. The SRO will focus on performing the following functions: ❖ Represent members in public discussions or with the concerned authorities. ❖ Establish minimum benchmarks, ethical and behavioral standards. ❖ Establish a uniform grievance redressal and dispute resolution framework. ❖ Conduct & promote research and development for creating a secure and safe ecosystem for investors.
Whitelisting of Tax Complying Exchanges	Every exchange/platform must provide and should be mandated for the submission of transaction records to the tax regulatory authority. This would help the tax authorities (CBDT) create a directory of 'valid' exchanges who are following the TDS norm. Alternately, CBDT can also act on a whitelisting approach wherein they would draft a list of exchanges that are deemed to be the only valid or safe ones for conducting business in India basis their following of due process of tax laws. All the other exchanges working in grey are not to be mentioned in the list, and thus be deemed unfit for business practice and declared illegal for executing any transaction by a resident of India. This is important as higher taxation regime in India has led investors shift to non-tax compliance international exchanges to evade taxes, making them prone to high risks. The said whitelist can also be shared with the Department of Consumer Affairs so that they can release an advisory for Indian consumers on the exchanges that are prohibited or potentially unsafe from a legal and procedural standpoint to be used for any transaction of VDAs. This will not only create an alerted awareness amongst the consumers about using such exchanges but also help current users of grey market exchanges to potentially shift to the whitelisted ones.

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