

Tax Insights

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Guidelines removing difficulties to implement withholding of tax provisions on payment on transfer of virtual digital assets

Background and legislative intent

- Virtual digital assets (VDAs) have gained tremendous popularity in recent times and the volumes of trading in such digital assets has increased substantially. In this regard, a new scheme to provide for taxation and withholding of tax pertaining to VDAs was introduced by the Finance Act, 2022.
- To withhold tax, the Finance Act, 2022, inserted section 194S in the Income-tax Act, 1961 (the Act) with effect from 1 July 2022.
- Section 194S of the Act places an obligation on a person to ensure that tax is withheld at the rate of 1% at the time of payment or credit of any sum to any resident as consideration for transfer of a VDA.
- The Central Board of Direct Taxes issued guidelines¹ on 22 June 2022 to remove difficulties in the implementation of section 194S of the Act.

Essential elements of section 194S of the Act

- On a bare reading of section 194S of the Act, the following key points emerge:
 - The person responsible for paying any sum to any resident in respect of transfer of a VDA is required to withhold tax at 1% on such sum.
 - Where payment is wholly or partly in kind, the person responsible for paying such consideration will ensure that tax has been paid prior to releasing such consideration.
 - The threshold amount triggering tax to be withheld is an aggregate payment of INR50,000 in case the specified person makes payment and otherwise INR10,000 in a financial year.
 - A specified person is an individual or Hindu Undivided Family who satisfies the conditions prescribed for this purpose in the section.
 - In case of specified persons, the requirement to obtain a Tax Deduction and Collection Account Number as per section 203A of the Act and the requirement to withhold tax at higher rates as per

¹ Circular No. 13 of 2022

section 206AB of the Act are not applicable.

- Where tax is withheld under section 194S of the Act, no tax is required to be withheld or collected under section 194-O of the Act.

Issues pertaining to implementation of section 194S of the Act

The industry had been facing some challenges regarding implementation of section 194S of the Act, some of which have been listed below.

- Lack of clarity on who will be the 'person responsible for paying' for trades where intermediaries such as an exchange or a broker are involved.
- If the buyer of crypto is considered as the person responsible for paying, and hence is required to withhold tax, how will the buyer get details of the seller if the trade is executed on an exchange?
- For transactions in kind (i.e., exchange of one VDA for another), how will the VDAs be valued, as no internationally accepted benchmarks are available for VDA and prices may vary by exchange?
- If payment gateways are used for transactions for transfer of VDA, can the payment gateways be considered as 'persons responsible for paying', and hence cast a withholding tax obligation on them?

Issues clarified by the guidelines

The guidelines have clarified the above and various other challenges that could arise in the implementation of section 194S of the Act. The guidelines primarily address issues on trades executed through exchanges. We have summarised the key clarifications below.

Transfer of VDA through an exchange or a broker

Trade executed on an exchange where a broker is the seller

- Tax may be withheld under section 194S of the Act by the exchange that is crediting or making payment to the seller (owner of the VDA being transferred).

Trade executed on an exchange where a broker is not the seller

- In a case where the credit or payment between an exchange and a seller is through a broker (and the broker is not the seller), the broker can take the responsibility to withhold tax if there is a written agreement between the exchange and the broker that the broker will withhold tax.

Trade executed on an exchange in cases where the VDA is owned by the exchange

- In a case where the VDA being transferred is owned by an exchange, the primary responsibility to withhold tax is of the buyer or his or her broker. As an alternative, the exchange may enter into a written agreement with the buyer or his or her broker that, regarding all such transactions, the exchange would be paying the tax.
- The exchange would be required to furnish a quarterly statement (Form No. 26QF) for all such transactions of the quarter on or before the due date and furnish its income tax return, including all such transactions in the return.

Transfer of VDA for consideration in kind through an exchange or a broker

- In case of transfer of VDA in kind or in exchange of another VDA through an exchange, while usually a buyer or seller is responsible for withholding tax, the exchange can take on the responsibility to withhold tax, based on a written contractual agreement with the buyer or seller. If such an alternative mechanism is exercised,
 - the exchange would be required to withhold tax for both legs of the transactions and pay to the government; and

- the buyer and seller would not be independently required to follow the procedure prescribed in proviso to sub-section (1) of section 194S of the Act.
- The guidelines also provide for a process that can be followed by exchanges for conversion of VDAs to INR for tax deposits. The process requires detailed records to be maintained to provide a complete trail for future reference. A contract note will need to be issued providing details of VDAs withheld and INR realised.

Section 194Q vis-a-vis section 194S

- Once tax is withheld under section 194S of the Act, tax would not be required to be withheld under section 194Q of the Act.

Consideration for withholding tax

- It is clarified that the tax required to be withheld under section 194S of the Act will be on the 'net' consideration after excluding the goods and services tax or charges levied by the deductor for rendering a service.

Withholding tax where payment gateways are involved

- The payment gateway will not be required to withhold tax under section 194S of the Act on a transaction, if the tax has been withheld by the person required to make the deduction under section 194S of the Act. The payment gateway could take an undertaking to this effect from the payor.

Calculation of threshold of INR50,000 or INR10,000

- The threshold of INR50,000 (or INR10,000) is with respect to a financial year, and hence will be considered from 1 April 2022 for the financial year 2022–23.

Credit or payment post 1 July 2022

- The provision of section 194S of the Act applies at the time of credit or payment (whichever is earlier) of any sum, representing the consideration for transfer of VDA. Any sum that has been credited or paid before 1 July 2022 would not be subjected to withholding tax under section 194S of the Act.

Way forward

Ensuring compliance

- Exchanges, brokers and users will be required to put in place documentation for effecting the alternative mechanism prescribed *vide* the circular.
- If trades are not executed through exchanges, the users will need to gear up for the withholding process.
- System changes will be required to implement the withholding processes, especially for brokers and exchanges.
- Parties will be required to maintain a detailed trail for transactions involving VDA-to-VDA exchange and ensure that appropriate broker notes are issued as required in the guidelines.

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