

EY Tax Alert

Central Government notifies inclusion of NFTs and exclusion of certain items from the scope of virtual digital asset

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Executive summary

This Tax Alert explains Notification Nos. 74 and 75 of 2022 dated 30 June 2022 issued by the Central Government (CG). Notification No. 74 excludes certain items like gift cards, mileage points, web subscriptions etc. from the scope of definition of "virtual digital assets" (VDA). Notification No. 75 notifies "token" which meets the definition of VDA as non-fungible token (NFT) but excludes NFTs representing ownership of underlying tangible assets from the scope of definition of VDA.

The Finance Act, 2022 introduced a separate scheme of taxation of income arising from transfer of VDA under Income Tax Laws (ITL)¹. For this purpose, the term VDA is defined widely under three limbs. The first limb covers any information or code or number or token (not being Indian currency or foreign currency) which meets certain conditions. The second limb covers NFT or any other token of similar nature, by whatever name called, but NFT itself is defined to mean such digital asset as the CG may, by notification in the Official Gazette, specify. The third limb covers any other digital asset, as the CG may, by notification in the Official Gazette, specify. The definition further authorizes the CG to issue notification to exclude any digital asset from the definition of VDA, subject to such conditions as may be prescribed therein.

¹ Income Tax Act, 1961

Accordingly, Notification No. 74 excludes the following VDAs from the definition of VDA:

- ▶ Gift card or vouchers being a record that may be used to obtain goods or services or a discount on goods or services.
- ▶ Mileage points, reward points or loyalty card, being a record given without direct monetary consideration under an award, reward, benefit, loyalty, incentive, rebate or promotional program that may be used or redeemed only to obtain goods or services or a discount on goods or services.
- ▶ Subscription to websites or platforms or applications.

The Notification No. 75 specifies a “token” which qualifies to be a VDA under the first limb as NFT under the second limb. However, it further provides that it shall not include NFT, whose transfer results in the transfer of ownership of underlying tangible asset and the transfer of ownership of such underlying tangible asset is legally enforceable.

The Notifications are effective from the date of publication in the Official Gazette i.e., 30 June 2022.

Background

- ▶ Finance Act 2022 introduced a new regime governing taxation of VDA under the ITL viz. definition of VDA, 30% tax on income arising from transfer of VDA, a new withholding provision @ 1% on consideration arising to a resident on transfer of VDA and amendment to apply gift taxation in the hands of recipient of VDA².
- ▶ For the purposes of the new regime, VDA is defined in a broad manner under three limbs as follows:
 - ▶ Limb A
 - It means any information or code or number or token (not being Indian currency or any foreign currency), **generated through cryptographic means or otherwise**, by whatever name called,
 - Providing a digital representation of value which is 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 and includes its use in any financial

transaction or investment, but not limited to investment scheme; and

- It can be transferred, stored, or traded electronically.

- ▶ Limb B

- A NFT or any other token of similar nature, by whatever name called. But NFT itself is defined to mean such digital asset as the CG may, by notification in the Official Gazette, specify

- ▶ Limb C

- any other digital asset, as the CG may, by notification in the Official Gazette, specify

- ▶ Exclusions:

- ▶ Indian currency or foreign currency as defined under Foreign Exchange Management Act, 1999 (FEMA) is excluded from the ambit of VDA. Thus, any instrument regarded as Indian currency or foreign currency is not considered to be a VDA.

- ▶ Separately, CG is empowered to exclude any digital asset from the definition of VDA subject to conditions as may be specified by CG.

- ▶ The definition of VDA was inserted w.e.f. 1 April 2022.

- ▶ On account of broad definition of VDA under Limb A, there was an apprehension whether it can potentially include non-crypto items like vouchers, reward points issued by shopping sites or credit card companies, airline miles, online subscription accounts, etc.

- ▶ In general parlance, NFTs are tokens which represent ownership in underlying tangible or intangible assets on blockchains, which can be bought and sold in a digital form. Unlike cryptocurrencies where the coins are homogenous, NFTs are non-fungible, i.e., non-interchangeable by nature such that each token is unique and has a value that is distinct from other tokens.

- ▶ Unlike crypto currencies or crypto assets which are not linked to any underlying assets, NFTs are linked to and derive their value from one or more underlying tangible or intangible assets such as digital pictures, videos, sport collectives, events, artwork or real estate. However, only the NFTs as notified by the CG are sought to be included in the scope of the definition of VDA. Until CG notifies a digital asset as VDA, Limb B of the definition would remain inactive. Since NFTs derive their value from underlying tangible or intangible asset which are

² Refer EY Budget Connect 2022 dated 1 February 2022- Tax Alert- Transaction tax

covered within regular scheme of taxation, stakeholders represented to CG to keep NFTs outside the scope of the new regime by not notifying any digital asset under Limb B of VDA definition.

CG Notifications:

- ▶ On 30 June 2022, the CG issued two Notifications under the definition of VDA which defines scope of NFT and the digital assets excluded from the scope of VDA.
- ▶ The CG Notifications are issued in backdrop of new withholding tax applicable on transfer of VDAs arising to a resident which becomes applicable from 1 July 2022. Earlier, the Central Board of Direct Taxes (CBDT)³ had issued circulars on various issues arising on transfer of VDA undertaken through Exchange⁴ and on peer-to-peer basis⁵.
- ▶ The CG Notifications are explained as under:

Notification No. 74:

- ▶ The CG has notified that following digital assets shall not be regarded as VDA for the purposes of ITL:
 - ▶ Gift card or vouchers, being a record that may be used to obtain goods or services or a discount on goods or services;
 - ▶ Mileage points, reward points or loyalty card, being a record given without direct monetary consideration under an award, reward, benefit, loyalty, incentive, rebate or promotional program that may be used or redeemed only to obtain goods or services or a discount on goods or services;
 - ▶ Subscription to websites or platforms or application

Notification No. 75:

- ▶ The CG has notified that a “token” which fulfils the definition of VDA under Limb A shall be NFT. But it shall not include a NFT whose transfer results in transfer of ownership of underlying tangible asset and the transfer of ownership of such underlying tangible asset is legally enforceable.

Comments

The CBDT Notifications provide much awaited clarification on scope of the definition of VDA. As a general principle, law effective on first day of assessment year (for instance, 1 April 2023) is considered to be applicable to whole of the tax year (2022-23). The Notifications are effective from the date of publication in the Official Gazette i.e., 30 June 2022 and would be in force on 1 April 2023. Thus, the Notifications may apply to transactions in VDA undertaken during whole of the tax year 2022-23.

Notification No. 74 addresses stakeholders concerns and excludes items like gift cards, vouchers, mileage points, loyalty points, subscription to website/apps, from the definition of VDA and consequently higher rate of tax at 30%, withholding provisions on transfer of VDA and gift taxation shall not apply to such items.

It is significant to note that the Notification No. 74 excludes only certain types of digital assets, like gift cards, vouchers, reward points, etc., which can be redeemed against future purchase of goods or service. It does not appear to exclude digital assets which can be redeemed for cash. Furthermore, it also does not exclude mileage points, reward points or loyalty card, which are purchased by direct monetary payment.

In Budget 2022, the Finance Minister had announced the introduction of Central Bank Digital Currency (CBDC) by the Reserve Bank of India using blockchain and other technologies. It is expected that such digital currency shall also be excluded from scope of VDA in due course.

In relation to NFTs, only those “tokens” which fulfil the definition of VDA under Limb A shall qualify as NFTs covered by the new regime. However, NFTs which are represented by underlying tangible assets and whose transfer results in a legally enforceable transfer of ownership of underlying tangible asset, are excluded from scope of NFT. Hence, NFTs which represent ownership in underlying intangible or digital assets like digital pictures, music, voice records, sports collectibles, etc. will be covered within the definition of VDA and consequently will fall under the new regime. As a corollary, NFTs represented by underlying tangible assets (like physical paintings) shall continue to be governed by the existing regular provisions of ITL.

Taxpayers may need to consider the scope of VDA in the light of above referred two Notifications to determine the tax implications under the new regime.

³ Apex administration body for direct taxes in India

⁴ Refer EY Alert titled - “CBDT issues guidelines for applying new withholding provisions on transfer of virtual digital assets” dated 23 June 2022

⁵ Refer EY Alert titled - “CBDT issues clarifications for applying new withholding provisions on peer-to-peer transfer of virtual digital assets not routed through exchange” dated 29 June 2022

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