Impact Assessment of 1% TDS on VDAs

A REPORT BY CHASE INDIA & INDUSLAW

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Overview

A crypto asset is generally considered as 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.[1]

At present, no legislation governs, regulates, or prohibits dealing in crypto assets in India. Therefore, it is not illegal to sell, purchase, deal, or mine crypto assets or set up a crypto asset exchange in India. While a 'Cryptocurrency and Regulation of Official Digital Currency Bill, 2021' was listed for introduction in Parliament's 2021 Winter Session[2] that sought to prohibit all "private cryptocurrencies" in India, the Bill however was not tabulated in the session. Finance Minister later in 2022 said that any legislation to regulate or ban cryptocurrencies can be effective only if it is globally coordinated with a synchronised approach[3]. The Minister also intended on the development of standard operating procedures (SOPs) for crypto. Recently, the Minister also urged G20 countries to examine the feasibility of bringing non-financial assets like cryptos under the ambit of automatic exchange of information among nations to check for tax evasion. In parallel later, crypto as a priority discussion was officially included in the Finance Track of India's G20 Presidency.[4]

A new framework in the form of a consultation paper is also being developed based on stakeholder consultations, including stances of foreign nations and supranational bodies on the adoption of cryptos. The consultation paper is expected to be released soon, and it is very likely that the decision on rolling out the plan for its treatment in India will be based on the global consensus

This fluctuating regulatory feasibility of cryptos has made the entry of the digital asset into conventional BFSI sector a rather uncongenial and unpredictable one. While many commercial banks seemed to be initially interested in dealing with cryptos, however, RBI's circular[5] to the regulated entities directing them not to provide services to businesses dealing in cryptos made banks gradually step away from the intended interest. While the Supreme Court quashed the circular, saying that it was unconstitutional, banks still are not sure of the approach to be taken. The developments going forward on the confluence of BFSI and cryptos will be worth looking forward to, on the variables of financial and technological innovation, as it can shape and potentially contribute to India's $5 trillion economy dream.

[1] https://www.investopedia.com/tech/why-crypto-asset-management-next-big-thing/
[2] https://loksabhadocs.nic.in/bull2mk/2021/23.11.21.pdf
[3] https://twitter.com/FinMinIndia/status/1567487655507824645
[4] https://www.g20.in/en/workstreams/finance-track/
[5] https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI15465B741A10B0E45E896C62A9C83AB938F.PDF

Key Aspects of VDAs 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,[6] to be included in Clause 47A under Section 2 of the Income Tax Act[7], 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. It is effective from July 1, 2022. 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. Various reports are in circulation at present of a probable GST to be implied on services and all activities related to crypto. The matter is still under discussion by the GST Committee.

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.

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

Crypto Sector and its Prospects in India

The crypto in India has gone a long way in a short time. Digital currency exchanges were virtually non-existent in India five years ago. Presently, India's crypto 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 crypto assets 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 crypto asset-related businesses that are yet to be invented[8].

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

Over 7% of India's population owns some category of crypto assets which rounds off to approximately 10 crore people, making it the highest number of crypto owners from one country across the globe.

The crypto sector has created about 50,000 employment opportunities in the country and this figure is anticipated to reach over 8,00,000 by 2030.

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

Indian crypto 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 crypto industry could reach US$1 trillion by 2025 with a progressive policy framework

India's crypto landscape is outshining its global counterparts, as it has the 2nd highest adoption rate in the world.

India's crypto market is poised to gain significant traction from increasing women participation in the crypto world.

Virtual digital assets have garnered particular traction among India's millennial population.

Sources:

- https://www.livemint.com/market/cryptocurrency/india-has-highest-number-of-crypto-owners-in-the-world-at-10-07-crore-report-11634110396397.html
- https://www.crebaco.org/downloads/KCO-CREBACO-India-Crypto-Representation.pdf
- https://www.financialexpress.com/market/over-8-lakh-jobs-likely-in-indias-crypto-market-by-2030-from-current-50000-report/2338187/
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- https://blog.chainalysis.com/reports/2021-global-crypto-adoption-index/
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Understanding 1% TDS on Crypto

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. (However, if anyone has done transactions (both buy and sell) for less than ₹10,000, TDS may not be applicable).

Deliberating more on the announcement, the Central Board of Direct Taxes (CBDT) issued a Circular (No. 13 of 2022)[9] 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.

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

Virtual Digital Assets Under Prevention of Money Laundering Act

Latest Developments in the Crypto Asset Sector

The crypto asset sector has been part of intense discussions among policy makers worldwide. India is no different and the entire world is keeping a close tab on the country's proceedings amid the ongoing G20 Presidency. The G20 discussions are aimed towards getting consensus from governments from across the world on crypto regulations.

As part of its presidency, India conducted the first G20 Finance Ministers and Central Bank Governors Meeting in February, where it was mentioned that the Financial Stability Board (FSB) is expected to submit high-level recommendations on the regulation, supervision and oversight of crypto-asset markets and activities by July 2023. This will be followed by the IMF-FSB Synthesis Paper in September 2023 which will support a coordinated and comprehensive policy approach to crypto-assets, by considering macroeconomic and regulatory perspectives, including the full range of risks posed by crypto assets.

The second G20 Finance Ministers and Central Bank Governors Meeting in April in Washington, the member countries deliberated on the macroeconomic and financial challenges posed by the crypto-assets ecosystem and exchanged views on potential global policy responses to crypto-assets, taking into account the risks, especially to Emerging Markets and Developing Economies (EMDEs).

India's Finance Minister Nirmala Sitharaman on multiple occasions reiterated that "crypto has been a very important part of the discussion under India's G20 presidency, given so many collapses and shocks. We seek to develop a common framework for all countries to deal with this matter". The stage has already been set and it's just a matter of time before the crypto asset sector will be regulated by a set of serious laws.

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 Virtual Digital Assets (VDA), including cryptocurrencies, 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 crypto 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 crypto 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 crypto 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 crypto 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 crypto 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.

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.[10] 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.[11]
- 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.[12]
- As another example of a crypto exchange platform, downloads shrank to 163,000 in August from 2.2 million in January.[13]
- 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.[14]

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.**

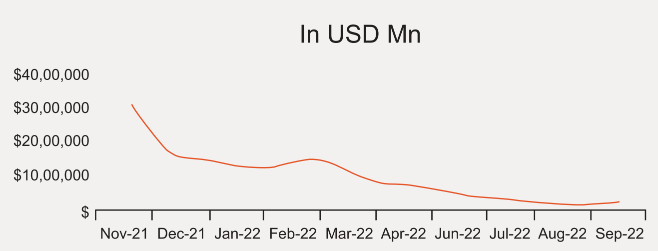

Figure 1: Trading volumes of major tax compliant Indian exchanges[15] (Graph shows downfall in volume post TDS implementation)

- 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.

[10] https://www.businesstoday.in/crypto/story/trading-volume-of-indian-crypto-exchanges-decline-after-application-of-1-tds-340718-2022-07-07
[11] https://www.livemint.com/market/cryptocurrency/crypto-traders-switch-to-foreign-exchanges-like-binance-to-escape-taxes-11663113422715.html
[12] 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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[14] https://news.bitcoin.com/indian-crypto-trading-volumes-plummet-after-new-tds-tax-rule-takes-effect/
[15] www.nomics.com

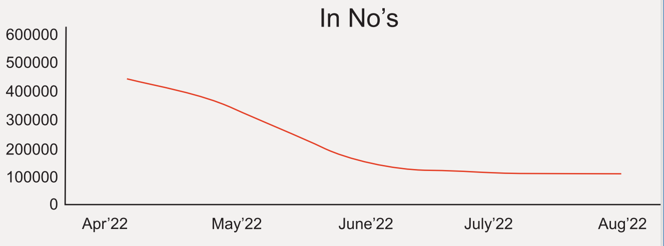

Figure 2: Apps installed for major tax compliant Indian exchanges[16]
(Graph shows reduced installations post TDS announcement and implementation)

- 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[17] 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.[18] 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*,[19] 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.[20] 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[21] – 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.**

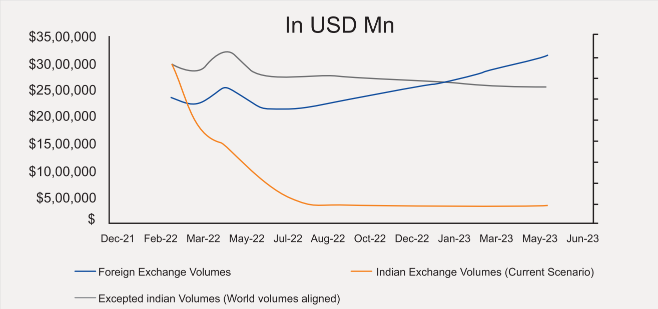

Figure 3: Volume comparison of major Indian tax compliant exchanges with foreign exchanges; with expected/forecasted volume[22]

- 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.

[16]https://www.bloomberg.com/news/articles/2022-09-13/crypto-traders-flee-indian-exchanges-for-binance-to-escape-taxes?leadSource=uverify%20wall
[17]https://www.livemint.com/market/cryptocurrency/crypto-traders-switch-to-foreign-exchanges-like-binance-to-escape-taxes-11663113422715.html
[18]https://news.bloombergtax.com/daily-tax-report-international/crypto-traders-flee-indian-exchanges-for-binance-to-escape-taxes?context=search&index=2
[19]https://www.businesstoday.in/crypto/story/what-is-crypto-gas-fee-and-how-do-nft-creators-negotiate-find-out-335751-2022-05-31
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[21]https://www.mckinsey.com/~/media/mckinsey/industries/retail/our%20insights/perspectives%20on%20retail%20and%20consumer%20goods%
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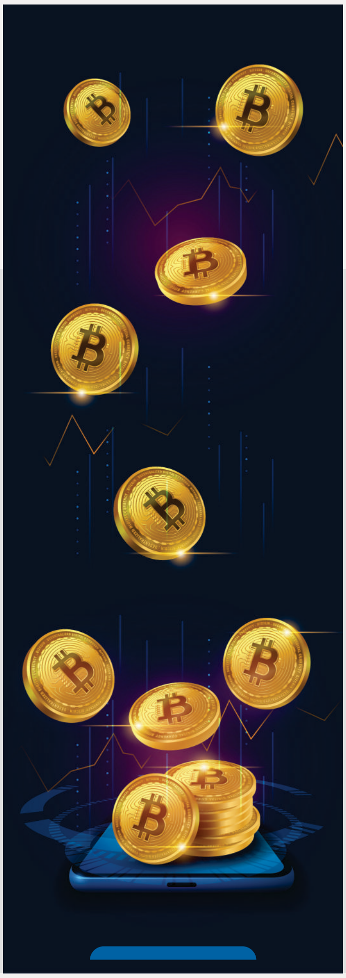
Innovation and Crypto Brain-Drain

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,[23] 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.[24] 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

Loss of Revenue



The impact of non-compliance of certain exchanges around the TDS norms will also have ripple effect in the government ecosystem. The TDS collected through the exchanges from investors adds to the government’s treasury, as a withholding tax, reducing liquidity and creating a loss of revenue in direct and indirect taxes. In the absence of certain exchanges contributing to the tax clause, the government will miss out on a potential revenue system generated through these trade channels. While the government is said to have collected around Rs. 60 crores from TDS on VDA,[25] the loss of revenue from potentially more taxpayers will be a noteworthy factor to ponder for the government who introduced the tax regime with the objective of taxing the income from VDA and crypto transactions, and some investors are now on the hindsight getting a ‘free pass’. Moreover, the introduction of the 1% TDS regime in itself has been criticized by the industry as it can have a ‘crippling’ effect on the investors as they would have less capital to indulge in more trading activities, and thus result in potential reduction in revenue for the government.[26] (According to an internal market study, 1% TDS on each trade results in erosion of almost 50% of the capital at ~70 trade and almost capital blocked by 280th trade). **The non-compliance scenario will only aggravate the situation of revenue loss.**

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

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[28]. 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.**

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

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.[29] 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.**

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
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. Further, the list can be accordingly also used by other government departments like the Ministry of Electronics and Information Technology (MeitY) who will ensure only these "whitelist" or "safe-list" exchanges or platforms are to be made available for download by users (traders) from different application stores. The said whitelist can also be shared with the Department of Consumer Affairs so that they can release an advisory for Indian traders on the exchanges that are prohibited or potentially unsafe from a legal and procedural standpoint to be used for any trading of VDAs and cryptos. 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.
Making KYC Mechanism Mandatory	The government, for the purpose of safety and oversight, must issue a notification to all exchanges/platforms to conduct a detailed e-KYC authentication on all investors/traders in line with the rules mentioned in Aadhaar (Authentication and Offline Verification) Regulations, 2021[30].The main advantages and benefits of introducing the service to the financial sector are: ❖ Repository of customers' personal information records and traders/investors account is created. ❖ Single source of personal information in providing all members with valid, authenticated, comprehensive, and updated KYC data. ❖ Safe and secure method to share confidential information ❖ Easier compliance with the regulator's requirements ❖ Instant verification against fraud ❖ Information and personal details are relayed timely and efficiently

[29] https://incometaxindia.gov.in/Acts/Finance%20Acts/1997/102120000000009149.htm
[30] https://uidai.gov.in/images/Draft-Aadhaar-Authentication-Regulations-2021.pdf

Customer Due Diligence	The platforms/exchanges must also perform customer due diligence to collect and evaluate relevant information about a customer or potential customer. The main aim of conducting due diligence is to uncover any potential future risk. The proper due diligence would: ❖ Ensure the investors remain compliant with the regulations and laws of the regions or markets they are operating in. ❖ Help make sure the customer is really who they say they are. ❖ Guard against fraudulent activity such as identity fraud or impersonation ❖ Assist and provide information to the law enforcement agency when required.
Reconsider 1% TDS on Crypto Trade	The existing 1% TDS on crypto 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. This would also enhance investors' confidence as now there would be greater oversight by the government, resulting in a cautious approach by the entities involved including banks, financial institutions and intermediaries. With this latest development, it is now the appropriate time for the authorities to reconsider the 1% TDS imposed on crypto transactions. 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 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. Therefore, it is important that India should incentivize users to stay within the ambit of domestic jurisdiction by reconsidering the TDS rate. A nominal TDS rate would also support tracking and tracing of transactions, thus aiding in tax collections if Indian investors continue to trade from Indian KYC enabled platforms.
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.
Awareness about different aspects of Crypto	Among many avoidable complications associated with cryptos, a lack of knowledge and understanding of virtual digital assets is the biggest obstacle, according to a survey conducted by The Economist Intelligence Unit 2021, 'Digimentality 2021'.[31] According to the survey results, 51% of respondents said a lack of knowledge is the main barrier to the adoption of open-source crypto, while 34% of survey participants cited security concerns as the main obstacle. Hence, in line with the aforementioned whitelisting recommendation, there is a need for educating authorities and investors on the implications of non-adherence of VDA-based TDS by certain grey market players. Awareness should incorporate the drawbacks and showcase the cascading impact that both the state and the investors would undergo if the current non-compliance persisted. Such awareness initiatives from the state with cooperation of the industry can have positive snow-ball effect and bring in the requisite change and create an ecosystem of making government authorities more vigilant and making crypto trading safer. In line with the above recommendation to create an SRO, it will also focus on addressing issues by analyzing the threats prevalent in the crypto ecosystem. The SRO will then curate an awareness session targeting primarily the investor. Going by the industry estimates of 3x growth in the global crypto market by 2030, the SRO must focus on educating people about the whole crypto ecosystem. Further, training sessions must be mandatorily conducted for LEAs on how to address any cyber fraud or consumer grievance being reported by investors/traders and what immediate course of action must be adopted for immediate redressal.

[31] https://digitalcurrency.economist.com/

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