

Taxation of Virtual Digital Assets: A Comparative Analysis of India and the UK

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Abstract

The rapid proliferation of Virtual Digital Assets (hereinafter referred to as “VDA”) has represent new challenges and opportunities for tax authorities across worldwide. This paper provides a analysis of the taxation regimes governing VDAs in India and the United Kingdom, examining the legislative frameworks, case laws, regulatory guidelines, and tax treatment approaches in each jurisdiction. It analyze the distinct strategies adopted by both countries, including India’s stringent flat-rate taxation model and the UK’s more nuanced approach, which differentiates between income tax and capital gains based on the nature of VDA transactions. The paper also discusses recent legal developments and cases that have shaped VDA tax policies in both nations. Furthermore, it identifies the challenges faced by policymakers, taxpayers, and the industry to comply with these taxation frameworks. The comparative analysis concludes with recommendations for harmonizing global tax policies on VDAs, enhancing regulatory clarity, and fostering a more balanced environment for innovation and compliance in the digital asset market.

Keywords: Virtual Digital Assets (VDAs), Cryptocurrency Taxation, Non-Fungible Tokens (NFTs), Tax Compliance, Anti-Money Laundering (AML), Global Tax Policy Harmonization.

1. Introduction

Virtual Digital Assets have rapidly emerged as a financial assets. As the popularity and use of these assets continue to grow globally, countries have agreed and responded by creating regulatory frameworks and tax policies to govern their use and ensure compliance. “The taxation of VDAs is a complex subject that involves several considerations, including the determination of their nature (whether as a currency, property, or financial instrument), their valuation, and the applicable tax rates¹.

Understanding Virtual Digital Assets (VDAs)

Virtual Digital Assets refer to any form of digital thing that represent the value that can be traded, transferred, or used for payments. Cryptocurrencies like Bitcoin and Ethereum, and Non-Fungible Tokens

¹ Dutta S., Income tax on virtual digital assets Under Section 115BBH, CA CLUB INDIA (5 May, 2022) available on <https://www.google.com/amp/s/www.caclubindia.com/amp/articles/income-tax-on-virtual-digital-assets-under-section-115bbh-47118.asp>

(NFTs) are the most popular forms of VDAs. Unlike traditional assets, VDAs are decentralized, meaning they are not created by a central authority like a bank or government.

Both India and UK have taken steps to create VDAs within their respective legal frameworks, although their approaches vary significantly. The tax treatment of VDAs depends on their classification under domestic law, which affects the applicable tax rate, compliance requirements, and reporting obligations.

2. Taxation of Virtual Digital Assets in India

2.1 Overview of India's Regulatory Landscape

India has approached VDAs cautiously. Initially, the Reserve Bank of India (RBI) imposed a blanket ban on the use of cryptocurrencies in 2018, which was overturned by the Supreme Court of India in 2020. Since then, the Indian government has been working on establishing a regulatory framework to govern the use and taxation of VDAs. The most significant step came in the form of the Finance Act, 2022, which introduced new provisions specifically targeting VDAs.

2.2 Classification and Definition

Under the Finance Act, 2022, VDAs are broadly defined to include any information, code, number, or token (not being Indian currency or foreign currency) generated through cryptographic means or otherwise, providing a digital representation of value. This wide definition captures cryptocurrencies, NFTs, and other digital assets within its ambit².

2.3 Tax Provisions for VDAs

- **Tax Rate:** The Indian government has introduced a flat tax rate of 30% on any income arising from the transfer of VDAs. This rate applies uniformly to all types of VDAs, irrespective of the holding period or the nature of the asset (whether it is a cryptocurrency or an NFT).
- **No Deduction Allowed:** No deduction, except the cost of acquisition, is allowed for expenses incurred in connection with the transfer of VDAs. This means that costs related to mining, transaction fees, and other expenses cannot be deducted from the income generated from VDAs.
- **1% TDS (Tax Deducted at Source):** A TDS of 1% is levied on all transactions involving VDAs. This provision aims to ensure that all VDA transactions are reported to the tax authorities. The threshold for TDS is set at INR 50,000 per annum for specified persons (like individuals or Hindu Undivided Families) and INR 10,000 for others.
- **Loss Carry Forward Not Permitted:** Losses arising from the transfer of VDAs cannot be set off against any other income nor can they be carried forward to subsequent years.

² Raote and Nagarsenkar M., Tax withholding on virtual digital assets, LIVEMINT (4 Jul., 2022) Available on <https://www.google.com/amp/s/www.livemint.com/news/india/tax-withholding-on-virtual-digital-assets/amp-11656933779442.html>

2.4 Reporting and Compliance Requirements

Taxpayers dealing in VDAs must disclose their income from such transactions in their annual tax returns. The tax authorities have also mandated the reporting of VDA transactions in specified formats, and non-compliance could result in penalties.

2.5 Criticism of India's Approach

India's approach has been criticized for its stringent tax provisions, particularly the high flat tax rate and the lack of deductions for expenses. Critics argue that this could stifle innovation and push the VDA market underground. Furthermore, the 1% TDS has been viewed as excessive, potentially impacting the liquidity and frequency of transactions in the market.

3. Taxation of Virtual Digital Assets in the United Kingdom

3.1 Overview of the UK's Regulatory Landscape

The UK has taken a more progressive approach toward the regulation and taxation of VDAs. The Financial Conduct Authority (FCA) is responsible for regulating certain activities involving cryptocurrencies, primarily focusing on anti-money laundering (AML) and counter-terrorist financing (CTF) measures. HM Revenue & Customs (HMRC), the UK's tax authority, has issued guidance on the tax treatment of crypto-assets, providing clarity to taxpayers³.

3.2 Classification and Definition

HMRC distinguishes between different types of crypto-assets and categorizes them as exchange tokens (like Bitcoin), utility tokens (which provide access to goods or services), and security tokens (which provide rights similar to investments). Each category is subject to specific tax rules depending on the nature of the transaction.

3.3 Tax Provisions for VDAs

- **Capital Gains Tax (CGT):** For individuals, the sale or disposal of crypto-assets is generally subject to Capital Gains Tax. The gains are calculated based on the difference between the sale price and the original purchase price, with allowances for certain costs. The applicable CGT rates are 10% for basic-rate taxpayers and 20% for higher-rate taxpayers. Each individual also has an annual CGT exemption allowance, which is £12,300 for the 2023/24 tax year.
- **Income Tax and National Insurance Contributions:** If an individual receives crypto-assets as a form of payment for employment or services rendered, they are treated as income and subject to Income Tax and National Insurance Contributions. Similarly, profits from mining activities, staking, or airdrops may also be taxed as income.

³ Magazine and Mukul P., TDS on transfer of virtual digital assets, applicable from July 1 — what the guidelines say, THE INDIAN EXPRESS (20 Jun., 2022) Available on <https://www.google.com/amp/s/indianexpress.com/article/explained/tds-on-transferof-virtual-digital-assets-applicable-from-july-1-guidelines-7986718/lite/>

- **Corporation Tax:** Businesses dealing in crypto-assets are subject to Corporation Tax on their profits. The rules for calculating these profits are similar to those for other financial instruments. Allowable deductions can be made for expenses incurred wholly and exclusively for business purposes.

3.4 Reporting and Compliance Requirements

UK taxpayers are required to report any gains or income from crypto-assets in their self-assessment tax returns. HMRC has also clarified that taxpayers must maintain detailed records of their transactions, including dates, values, and the nature of the transactions. Failure to report could result in penalties.

3.5 Criticism of the UK's Approach

The UK's approach to VDA taxation has been praised for its clarity and flexibility. However, some critics argue that the differentiation between income tax and capital gains tax treatment can be confusing for taxpayers. Additionally, while the UK has not introduced a specific VDA tax rate, the standard CGT rates could still be viewed as burdensome, particularly for frequent traders⁴.

4. Comparative Analysis of Taxation Frameworks

4.1 Key Differences in Approach

- **Classification and Definition:** India has adopted a broad definition of VDAs, while the UK provides a more nuanced categorization. This reflects a fundamental difference in their approaches — India's strategy is more restrictive, while the UK aims to provide clarity and flexibility.
- **Tax Rates and Basis:** India imposes a flat 30% tax rate on all VDA transactions, whereas the UK applies CGT or income tax based on the nature of the transaction. The UK's rates are generally lower than India's flat rate, especially for basic-rate taxpayers.
- **Deductions and Loss Carry Forward:** The UK allows deductions for expenses and losses to be set off against other income, while India permits no such deductions or loss carry-forwards. This makes the UK's approach more favorable to businesses and frequent traders.
- **TDS Provisions:** India's 1% TDS on all VDA transactions is a unique feature not found in the UK. This mechanism is designed to improve tax compliance but could impact market liquidity.

4.2 Compliance and Reporting Requirements

Both India and the UK require taxpayers to report VDA transactions, but the UK's record-keeping requirements are more detailed. India's approach, while simplified by the flat tax rate, may deter transactions due to its stringent provisions⁵.

⁴ Murali. A, Two young Indians turn to Supreme Court to make laws around Bitcoin, cryptocurrencies less turbid, FACTOR DAILY (14 Nov., 2017) Available on <https://archive.factor-daily.com/bitcoin-regulation-pil-supreme-court/>

⁵ Ranga, S and Ali. F, Virtual Digital Assets in India: A Sneak Peek into India's Regulatory Framework, MONDAQ (22 Feb., 2022) Available on <https://www.mondaq.com/india/fin-tech/1164634/virtual-digital-assets-in-india-asneak-peek-into-india39s-regulatory-framework>

5. Implications for Investors and Traders

5.1 Impact of High Tax Rates in India

The high flat tax rate and lack of deductions in India could deter retail investors and traders. High-frequency traders, in particular, may find the 30% rate prohibitive. Moreover, the 1% TDS could reduce the liquidity of the market, potentially leading to a reduction in overall trading volume and impacting price discovery mechanisms.

5.2 Favorable Conditions for Businesses in the UK

The UK's approach, which includes CGT for disposals and income tax for certain types of income, provides more favorable conditions for businesses and institutional investors. The ability to deduct expenses and set off losses is beneficial for businesses operating in the crypto-asset space, encouraging innovation and growth.

6. Challenges and Future Outlook

6.1 Challenges in India

India faces multiple challenges in effectively implementing its tax framework for Virtual Digital Assets (VDAs). The country's stringent tax rate of 30%, combined with a lack of allowances for deductions other than the cost of acquisition, creates an environment that may discourage compliance and participation in the formal VDA market. Several key challenges include:

- **Compliance and Enforcement:** The decentralized nature of VDAs makes it challenging for Indian tax authorities to track and monitor transactions, especially those conducted on international or decentralized exchanges. The imposition of a 1% Tax Deducted at Source (TDS) on VDA transactions is intended to create a paper trail, but it may not be enough to ensure full compliance, particularly with cross-border transactions.
 - **Risk of Informal Market Growth:** A percentage of VDA trading may shift to unregulated peer-to-peer (P2P) platforms or international exchanges due to the high tax rate and the onerous TDS method. A parallel, unreported market could result from this change, making it more challenging for the government to collect taxes.
 - **Regulatory Uncertainty:** There is still a lack of thorough regulatory clarity even though India has begun to develop a legal framework for VDAs. The lack of a specific cryptocurrency law raises questions about how the current tax laws will handle other related activities like lending, staking, and DeFi (Decentralised Finance) operations. This uncertainty may cause disagreements between authorities and taxpayers, which may lead to legal action.
1. **Impact on Innovation and Investment:** The present tax structure may discourage investors and businesses from joining the VDA ecosystem, which would restrict the development of blockchain and cryptocurrency technology in India. The environment is less appealing to both domestic and foreign investors due to the flat 30% tax rate and the inability to deduct or offset losses.
 2. **Internet and Mobile Association of India v. Reserve Bank of India (2020)** The legality of a circular issued by the Reserve Bank of India (RBI) in April 2018 that forbade banks and financial

institutions from dealing in virtual currencies or offering services to any entity or individual involved in their transactions was examined by the Supreme Court of India in this historic case. The Internet and Mobile Association of India (IAMAI) spearheaded the petitioners' argument that the RBI's circular was illegal, without legal support, and essentially prohibited the usage of cryptocurrencies in India. In its 2020 decision, the Supreme Court invalidated the RBI circular, claiming that it was excessive and that there was no law that prohibited cryptocurrency trading. The court's ruling was crucial.

3. **Nangia Andersen LLP v. The Union of India (2022)** The Delhi High Court received this case, which contested the legality of the Finance Act of 2022's requirement that 1% Tax Deducted at Source (TDS) be applied to transactions involving virtual digital assets. Nangia Andersen LLP, the petitioner, contended that the 1% TDS was arbitrary, disproportionate, and hindered the expansion of the VDA market by having a major impact on trading volume and liquidity. The court acknowledged the petitioner's worries about the possible negative effects on the VDA market and liquidity, even if it did not grant immediate relief or stay the provision⁶. The case highlighted the ongoing debates around the taxation of VDAs in India, particularly the balance between revenue generation and market development.
4. **Sandeep Goenka v. Union of India (2022)** Sandeep Goenka v. Union of India is another noteworthy case in which the petitioner contested the high flat tax rate of 30% levied on VDA revenue under the Finance Act, 2022. In contrast to how other types of capital gains or investments are treated, the petitioner contended that the high rate and the ban on deductions other than the cost of acquisition were punitive and discriminatory. The case raised awareness of India's strict VDA tax laws and their possible effects on the growth of the sector. Even though the court did not immediately rule in the petitioner's favour, it did spark debate on whether India's VDA tax system is consistent with the nation's larger economic objectives.

5. Case Laws in the United Kingdom

1. **FCA v. Gidiplus Limited (2022)** Concerned about Gidiplus's adherence to anti-money laundering (AML) laws, the Financial Conduct Authority (FCA) filed a lawsuit against the cryptocurrency exchange company in the case of FCA v. Gidiplus Limited. The FCA's decision to deny Gidiplus Limited's request to continue trading was examined by the UK Upper Tribunal, which pointed to insufficient AML procedures and policies. The case's conclusion affected how VDAs are taxed in the UK, even though its main focus was regulatory compliance. It emphasised that in order for cryptocurrency companies to continue functioning lawfully in the UK, they must adhere to both tax duties and more general regulatory requirements, such as anti-money laundering regulations.

⁶ Pachal D., Explained: What are virtual digital assets and how are they different from digital currency? , THE INDIAN EXPRESS, (2 Feb., 2022) available on <https://www.google.com/amp/s/indianexpress.com/article/explained/virtual-digitalassets-vs-digital-currency-explained-7752936/lite/>

2. **HMRC v. Elson (2021)** The classification and taxes of gains from cryptocurrency trading were at issue in the case of HMRC v. Elson. The taxpayer maintained that the profits should be classified as capital gains, but HM Revenue and Customs (HMRC) argued that they should be treated as taxable income. In the end, the court agreed with HMRC and decided that gains from cryptocurrency trading could be taxed as income, particularly if the transactions are regular and show traits of trade. Depending on the type and frequency of transactions, this judgement clarified how various VDA transaction types are handled under UK tax legislation, including making a distinction between income tax and capital gains tax.
3. **HMRC v. Brian Armstrong (2020)** A UK taxpayer was found to have underreported revenue from a variety of cryptocurrency transactions in the case of HMRC v. Brian Armstrong. HMRC pursued the case, claiming that Armstrong had not paid the proper taxes and had not disclosed substantial profits from cryptocurrency trading activities. Armstrong was ordered to pay the taxes due, plus interest and penalties, after the court decided in favour of HMRC. The case reaffirmed HMRC's position on the significance of complete disclosure of VDA transactions and reaffirmed its resolve to use the judicial system to enforce compliance. It also emphasised how crucial it is for taxpayers to maintain thorough records of every VDA transaction in order to prevent fines.

6.2 Challenges in the UK

The UK's relatively progressive approach to VDA taxation is not without its challenges. Some of the issues faced by the UK include:

- **Complexity in Classification and Treatment:** Exchange tokens, utility tokens, and security tokens are distinguished in the UK, and each has its own set of tax regulations. Although this classification makes things clearer, it also makes things more complicated for taxpayers because they have to deal with different tax treatment depending on the kind of VDA and the transaction. For instance, it can be difficult to decide whether income from staking should be considered capital gains or income, and additional advice may be needed.
- **Ambiguities in Application:** Even with the extensive guidelines provided by HM Revenue & Customs (HMRC), there are still some situations where it is unclear how tax laws apply to VDAs. For instance, it is unclear how new financial products such as derivatives connected to cryptocurrencies or decentralised finance (DeFi) instruments would be treated tax-wise. Inconsistent tax reporting and possible lawsuits may result from this issue.
- **Enforcement and Compliance:** Although there isn't a specific tax on VDAs in the UK like India's TDS, it can still be difficult to ensure compliance. Because cryptocurrencies are decentralised, it is challenging for tax authorities to monitor transactions, especially when they take place on private or foreign platforms. Because HMRC depends on self-reporting, it needs strong auditing tools to find non-compliance.
- **Global Coordination and Double Taxation:** Transactions that are taxable in multiple jurisdictions run the danger of double taxation because VDAs are traded internationally. In order to prevent double taxation and make sure that taxpayers are not unfairly penalised for cross-border transactions, the UK will need to collaborate with other nations to create clear regulations.

6.3 Future Outlook

For India:

India's tax regime for VDAs is likely to evolve in response to feedback from market participants and the global regulatory landscape. Some potential future developments include:

- **Revising the Tax Rate and Deductions:** To encourage compliance and foster a conducive environment for growth, India may consider reducing the flat tax rate on VDAs or allowing deductions for certain expenses. Additionally, the government could re-evaluate the 1% TDS provision to balance the need for compliance with the desire to maintain market liquidity.
- **Regulatory Clarifications:** As the market matures, the Indian government may issue more detailed guidance or regulations to address uncertainties related to the tax treatment of different types of VDAs, including DeFi activities, staking rewards, and airdrops. The development of a comprehensive regulatory framework, possibly in the form of a dedicated cryptocurrency law, could help resolve these ambiguities.
- **Enhancing Compliance Mechanisms:** To improve compliance, the Indian government may leverage technology such as blockchain analytics tools to monitor transactions more effectively. Partnerships with international regulators and exchanges could also help identify and track cross-border transactions, reducing the risk of tax evasion.
- **Developing a Global Consensus:** India could work towards developing a global consensus on the taxation of VDAs through international bodies such as the G20 or the OECD. Coordinated efforts could help address issues related to cross-border transactions and ensure a level playing field for all countries⁷.

For the UK:

The UK's approach is already more established and flexible, but future changes may focus on refining and clarifying the existing framework:

- **Providing Clearer Guidance:** HMRC may issue further guidance on the treatment of emerging areas within the VDA ecosystem, such as DeFi, staking, and yield farming, to reduce ambiguity and ensure consistent tax treatment.
- **Strengthening Compliance and Enforcement:** The UK could enhance its compliance framework by leveraging technology and international cooperation to track VDA transactions more effectively. HMRC may continue to work closely with international tax authorities to combat tax evasion and ensure compliance.

⁷ Dua S., Tax on crypto, virtual assets decoded, THE ECONOMIC TIMES (24 Jun., 2022), available on-<https://m.economictimes.com/wealth/tax/tax-on-crypto-virtual-assetsdecoded/what-does-the-law-on-tds-on-vda-crypto-say/slideshow/92429435.cms>

- **Reviewing Tax Policies:** The UK government may review its tax policies to ensure they remain competitive while fostering innovation within the VDA sector. Adjustments could be made to capital gains tax rates or allowances to promote investment and growth.
- **Collaborating Internationally:** As a global financial hub, the UK is likely to play a key role in shaping international tax policies for VDAs. Active participation in global discussions on standardizing VDA taxation could help mitigate the risks of double taxation and regulatory arbitrage”.

7. Conclusion

The taxation of Virtual Digital Assets is a complex and evolving issue, shaped by each country's unique regulatory environment, economic objectives, and market dynamics. India and the UK represent two distinct approaches to VDA taxation: India's more stringent and flat-rate model contrasts with the UK's flexible and nuanced framework. Each approach has its own strengths and challenges, reflecting different policy priorities and market conditions⁸.

Both nations will probably improve their tax laws to strike a balance between generating income and encouraging innovation and compliance as VDAs continue to rise in importance in the world of finance. In order to handle the benefits and challenges posed by this new asset class, the future of VDA taxes will rely on continuous legal changes, technological breakthroughs, and international collaboration. In order to establish equitable and sustainable taxation systems that foster growth and guarantee efficient regulation and compliance, both India and the UK would need to manage these difficulties.

⁸ Shah. K., A new era in taxes has kicked in with taxation of virtual digital assets. But, what next?, EY (22 Apr., 2022) available on- https://www.ey.com/en_in/tax/why-taxation-of-virtual-digital-assets-still-needs-clarity