

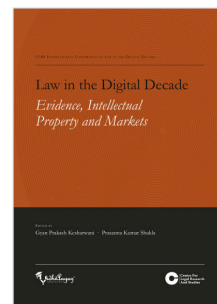
CHAPTER 19

The Janus Paradox: Evaluating Tax Friction, Regulatory Blind Spots and Capital Flight Under the Indian Virtual Digital Assets Regime

Tarun Kumar Srivastava and Keshav

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CHAPTER 19

The Janus Paradox: Evaluating Tax Friction, Regulatory Blind Spots and Capital Flight Under the Indian Virtual Digital Assets Regime

TARUN KUMAR SRIVASTAVA* AND KESHAV**

Virtual Digital Assets (VDA) are constructed using cryptography, exist in intangible form, and are identified by incorporating an electronic document into the electronic transaction record, with commercial significance. The inclusion of cryptographic technology into the global financial regime has formulated a ‘decentralised’ system that challenges the traditional legal framework. VDAs’ autonomous operating capability enables them to serve as a system protected by an encryption algorithm, for both a virtual accounting system and a medium of exchange. This study highlights and examines the structural regulatory gap in the statutory framework governing VDAs, as reflected in the Finance Act and the Prevention of Money Laundering Act. While the statutory provisions and Financial Intelligence Unit-India (FIU-IND) reporting directives treat VDAs primarily as a subject of revenue collection and transaction monitoring, this paper, by applying a mixed-method methodology combining doctrinal statutory implications of tax and Anti-Money Laundering (AML) framework with scientific market volume implications in the Indian regime, analyses the operational and practical impacts of these provisions. This paper demonstrates that stringent fiscal measures, especially a 30% flat tax without a loss set-off and a Tax Deducted at Source (TDS) of 1% on the gross transactional value, impact liquidity in the domestic market, creating a ‘tax leakage’ by trading a significant amount into offshore platforms, undermining the enforcement goals of FIU-IND. This paper also explores the jurisdictional gap of self-hosted wallets and automated smart contracts, which is created through the reliance of PMLA on centralised reporting entities. This paper suggests a statutory framework to establish property rights by changing the 1% TDS regime to 0.01% to conserve transaction tracking without impacting market liquidity, enable same-class loss set-offs, and enforce forensic monitoring to address the cryptographic architecture.

Keywords: Virtual Digital Assets, Cryptographic Technology, Finance Act, Prevention of Money Laundering Act, Tax Leakage.

1 INTRODUCTION

Virtual Digital Assets (VDAs), also called ‘electronic assets’, are constructed using cryptography, exist in intangible form, and are identified by incorporating an electronic document into the electronic transaction record, with commercial significance.¹ VDAs incorporate virtual goods and services, tokens and cryptocurrencies, which create difficulties and problems for the Indian economy and monetary canon.² In India, the use and influence of VDAs increased significantly after the Supreme Court (SC) set aside the circular of the Reserve Bank of India (RBI) of 2018, by which it directed regulated financial institutions to cut off access to VDAs, and held that, as there is no statutory framework enacted by the

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¹ Income Tax Act 1961 § 2(47A) (inserted by Finance Act 2022).

² Id.; Ministry of Finance, Reply to Lok Sabha Starred Question No. 10 (Cryptocurrency) (July 18, 2022).

Parliament that prohibits the use and access of VDAs, the executive body cannot deny the use of monetary and commercial assets of any form to the citizen as it violates the citizens' right of freedom, which a person has, to carry on his business which is incorporated under Article 19(1)(g)³ of the Indian Constitution.⁴ The Parliament, in 2022, enacted the Finance Act⁵ by amending the Income Tax Act⁶ to impose tax on the income generated through VDAs, where the Parliament introduced Section 115BBH⁷ to impose a flat tax of 30% on profits earned without allowing intra-asset loss offset, and also included Section 194S⁸, which imposes 1% tax on gross transactions. The central government also increased the scope of Section 2(1)(sa)(vi)⁹ of the Prevention of Money Laundering Act by including Virtual Asset Service Providers (VASPs), including custodial service providers and transfer-intermediary applications. Accordingly, digital asset middlemen are specified as 'reporting entities' dependent on customer due diligence (KYC), business registration compliance, and compulsory filing of Suspicious Transaction Reports (STRs) with the Financial Intelligence Unit-India (FIU-IND).¹⁰ All these provisions act as a tool for the supervision and monitoring of virtual digital assets, but all these provisions have a deficiency in any civil consumers' remedies and primary ownership rights, as the current statutory provisions lack codification in the Indian legal system.

2 BACKGROUND

2.1 Conceptual Background

In the Indian legal system, the Virtual Digital Asset (VDA) is outlined and interpreted in section 2(47A)¹¹ of the Income Tax Act, as a cryptographically created cypher, numerical code, or emblem enabling a virtual depiction of value that can be transmitted, stored, or traded electronically, expressly excluding fiat currencies. In the contemporary system, these assets operate in two parallel models: a centralised, integrated system and a decentralised, distributed system. The centralised and amalgamated system mimics the non-contemporary financial system, which includes sustained control over its consumers' private cryptographic keys and enables customers to manage domestic off-chain ledgers to assist fiat-to-crypto liquidity.¹²

By contrast, decentralised, distributed, self-hosted systems like wallets enable transfer and transaction on a peer-to-peer basis in a distributed system, which enables customers to access and possess their own private keys and eliminate tech intermediaries. Any transmissions among the customers are governed through 'smart contracts', which include predetermined, self-enforcing software code which is based on a 'public blockchain' that automatically resolves the transfer of tokens if the system's mathematical calculations are met, totally sidestepping human intervention. Whereas the centralised mechanism operates

³ INDIAN CONST. art. 19, cl. 1(g).

⁴ Internet and Mobile Association of India v. Reserve Bank of India, AIR 2020 SC 298.

⁵ Finance Act 2022.

⁶ Income Tax Act 1961.

⁷ Income Tax Act 1961 § 115BBH.

⁸ Income Tax Act 1961 § 194S.

⁹ Prevention of Money Laundering Act 2002 § 2(1)(sa)(vi).

¹⁰ 7 ADVAIT SHARMA, REGULATION OF VIRTUAL DIGITAL ASSETS UNDER PMLA IN INDIA 112, 115-120 (International Journal of Management and Humanities 2024).

¹¹ Income Tax Act 1961 § 2(47A).

¹² 2 KUMAR RISHAV AND DIVYA VENUGOPALAN, THE DIGITAL ERA: CRYPTOCURRENCY AND ITS (IN)EFFICIENT TAXATION AND REGULATION POLICY 91, 95-99 (HPNLU Journal of Taxation Law 2023).

within a traditional statutory framework enabling the role of intermediaries, the decentralised system executes on the doctrine of smart contracts, opposing the conventional framework by operating without any corporate intermediaries.¹³

2.2 Historical Background

In the Indian legal system, VDAs, their concept and their regulatory approach have evolved continuously over a period of time. The VDAs were introduced in the early 2010s in India, which was a new concept for the general public as well as for the government.¹⁴ Between 2013 and 2018, the Reserve Bank of India (RBI) adopted a cautionary and admonitory stance toward VDAs, where the RBI issued public advisories warning the general public against the monetary, functional, and statutory risks of VDAs.¹⁵ Further, in 2018, the RBI implemented a constructive ‘ring-fencing’ framework, which forbade regulated banking enterprises from rendering any VDAs and cryptographic asset-related services to users and customers. In 2020, the ban on VDAs and other cryptographic assets was challenged in court, and the court struck down the ban and held that the complete administrative ban on VDAs and other cryptographic assets without any scientific or latent harm violates Article 19(1)(g)¹⁶ of the Indian Constitution.¹⁷ In the aftermath of the judicial precedent, the Parliament enacted the Finance Act and formulated the tax regime, in which it introduced an imposition of a 30% tax on profits and an imposition of a 1% tax on gross transactions.¹⁸ Ultimately, in 2023, the central government incorporated the concept of VDAs and other cryptographic assets into the provisions of the Prevention of Money Laundering Act (PMLA) statutory framework, where it made compulsory the filing and reporting in conformity with FIU-IND.¹⁹

2.3 Theoretical Background

This paper evaluates the administration of VDAs in the Indian legal and administrative system by evaluating three core principles. First and foremost is the Janus Model of administration, which asserts the push and pull of the act of the state and the objective of the regulation. The Parliament has imposed a flat tax of 30% on profits earned by the customers of VDAs and a tax of 1% on gross transactions, where the Parliament has adopted restrictive measures aimed at direct control of VDAs, and restricts the trading of VDAs in the Indian fiscal system. This measure of Parliament directly opposes the objective of the anti-money laundering motto of the state, where the main objective is the decentralised regulation of the market, and supports the principle of *laissez-faire*. Both the objective and statutory framework of the state are a paradox (Janus) in themselves, where both frameworks are in conflict with each other but also co-exist with each other.²⁰

Second is the principle of ‘Economic Analysis of Law’, which asserts that when the tax slab and its regulatory compliance are greater than the acceptable length, it leads to tax evasion and the transfer of

¹³ 33 KEVIN WERBACH, TRUST BUT VERIFY: WHY THE BLOCKCHAIN NEEDS THE LAW 478, 501-512 (Berkeley Tech. L.J. 2018).

¹⁴ RISHAV, *supra* note 12, at 100.

¹⁵ 4 SHREYA SINGH, CRYPTOCURRENCIES: UNRAVELLING REGULATORY REALITIES AND TAX FRAMEWORK 1, 3-6 (Indian Journal of Integrated Research in Law 2024).

¹⁶ INDIAN CONST. art. 19, cl. 1(g).

¹⁷ Internet and Mobile Association of India v. Reserve Bank of India, AIR 2020 SC 298 ¶ 220-225.

¹⁸ VIKASH GAUTAM, VIRTUAL DIGITAL ASSET TAX ARCHITECTURE IN INDIA: A CRITICAL EXAMINATION 6 (Esysa Centre Special Issue No. 208, 2023).

¹⁹ SHARMA, *supra* note 10, at 115, 120-122.

²⁰ RISHAV, *supra* note 12, at 101-103.

money from Indian territory into offshore accounts and non-compliant locations.²¹ Third is the doctrine of ‘code is law’, which was developed by Lawrence Lessig, which asserts the legal non-alignment between the statutory framework and the contemporary decentralised, automatic, systematic algorithm.²² The conventional statutory framework asserts the presence of an intermediary, such as a corporate entity or a natural person, who can be held liable for any breach; the contemporary decentralised algorithm operates on the concept of smart contracts and localised wallets, where there is little involvement of any intermediaries. This establishes a statutory gap where the legal provisions have not evolved in line with the evolution of the algorithm of the tax regime.

3 OBJECTIVE OF THE STUDY

This paper explores the statutory rules under section 2(47A)²³, section 115BBH²⁴ and section 194S²⁵ of the Income Tax Act. This paper articulates the PMLA rules of reporting and how they are applied to the contemporary VDAs and other cryptographic algorithms. This paper examines the transmission of currency from Indian trading and monetary platforms to foreign offshore accounts and destinations. This paper analyses and identifies the gap in the statutory framework, which includes the property and possession rights of an individual, the safety of investors and the decentralised algorithm of e-wallets. This paper suggests a balanced approach for new statutory and planning reforms, which is appropriate for the contemporary Indian tax regime.

4 RESEARCH METHODOLOGY

This paper utilises a mixed Theoretical-Practical approach, where this paper analyses the enacted legal provisions of the Income Tax Act, PMLA Rules, parliamentary notifications, administrative notifications, and precedents, with research data on market quantity response to the novel statutory provisions of tax. The primary source of data includes the Income Tax Act, Finance Act, PMLA and precedents of the court, and the secondary source includes reports of think tanks, academic articles, etc. This paper relies on market evidence, as the tax documents of the individual and the details of foreign accounts and destinations cannot be accessed.

5 ANALYSIS AND FINDINGS

5.1 The Tax Regime and Its Application

The Indian tax statutory regime has incorporated provisions in the Income Tax Act that have an impact on the Indian fiscal market and its structure. Section 2(47A) has endorsed an extensive, tech-driven explanation incorporating any virtual goods and services, tokens derived through the process of cryptography, which fails to differentiate between a monetary token and its operative usefulness or

²¹ SINGH, *supra* note 15, at 10-11.

²² LAWRENCE LESSIG, CODE: VERSION 2.0, at 1-15 (Basic Books 2006).

²³ Income Tax Act 1961 § 2(47A).

²⁴ Income Tax Act 1961 § 115BBH.

²⁵ Income Tax Act 1961 § 194S.

administrative possessions.²⁶ Section 115BBH imposes a flat tax of 30% on profits earned, with strict and rigid statutory provisions that disallow the deduction of any expenditure other than the cost of acquisition, including intermediary fees or blockchain operational costs, and also does not allow intra-asset loss offset, where a gain in one transaction offsets a loss in another transaction. This statutory framework imposes a great burden on the taxpayers and other market players. Take a market investor who gains a profit of Rs. 30,000 in Token 1 and subsequently incurs a loss of Rs. 30,000 in Token 2. Yet, the market investor is liable to pay 30%, i.e. Rs. 9,000 (Rs. 9,360 with the 4% health and education cess), as a direct tax. Moreover, Section 194S states a compulsory responsibility to deduct 1% as Tax Deducted at Source (TDS) on the gross revenue of each transaction. This framework imposes a burden upon the market users, wherein a market investor secures a margin of 0.20% in his transaction, and the statute imposes a burden of 1% TDS. This leads to the depletion of venture assets, making the market considerably less attractive for investment.

5.2 Market Movement

The enactment of the Finance Act had a significant impact on the market and its reorganisation. Within three months of its implementation, the everyday collective business volumes decreased by 90%,²⁷ where it came from transactions of millions of dollars to a negligible level. This phenomenon led to the event of ‘offshoring’, where, in reality, the demand of the market did not reduce, but the allocation and investment of capital in the form of profit was shifted from the Indian fiscal market to offshore markets and destinations. A business volume of \$3.8 billion was transmitted to the offshore destinations, which has not only impacted the capital market but also the tax collection of the Indian fiscal regime.²⁸ Moreover, the ‘on-chain’ measures specified that there is a prominent shift from highly regulated intermediaries and obligations to autonomous e-wallets, which are privately held and do not impose high obligations upon their users. The shift to decentralised algorithms has led to the flow of money outside the range of the domestic banking system, which has affected the whole function of lending and investment by banks, individuals or organisations into small businesses, enterprises, or any developmental project or infrastructure.

5.3 The Implementation and Restriction of PMLA

The Prevention of Money Laundering Act was enacted by Parliament to prevent money laundering and encourage the free flow of the economy and investment in the market. In March 2023, the central government notified VDA service providers as ‘reporting entities’ under section 2(1)(sa)(vi)²⁹ of the Prevention of Money Laundering Act, where there were mandatory provisions for Know Your Customer (KYC), preservation of a five-year transaction register and filing of Suspicious Transaction Reports (STRs) with the Financial Intelligence Unit-India (FIU-IND). The statutory framework of PMLA has three main issues. First and foremost is the ‘intermediary issue’, where the conventional structural framework of PMLA includes a structural middleman that can be held accountable for any breach of conduct.

²⁶ 9 MAYANK JAIN AND TANYA SARASWAT, DECIPHERING SECTION 2(47A): THE OVERBREADTH OF VIRTUAL DIGITAL ASSET DEFINITIONS UNDER INDIAN TAX LAW 118, 122-126 (National Law University Delhi Law Review 2023).

²⁷ *Id.* at 120.

²⁸ GAUTAM, *supra* note 18, at 4, 22 (cumulative trade volume of around USD 3,852 million shifted from Indian to foreign centralised VDA exchanges during Feb.–Oct. 2022).

²⁹ Prevention of Money Laundering Act 2002 § 2(1)(sa)(vi).

But, in the contemporary transactional framework like the peer-to-peer (P2P) model, where a transaction is concluded between two people without the presence of any intermediary, like when a person transfers a bitcoin from their hardware to another's, there is no presence of any unified structure to maintain KYC or to follow the FATF travel rule. This escapes the ambit of the PMLA statutory framework.

Second is that Section 17³⁰ of the PMLA provides for the search of premises and the seizure of records, on which marks of identification may be placed, but the section cannot be implemented effectively as the VDAs operate on a decentralised monetary policy with smart automatic contracts, where decentralised exchanges such as Curve or Uniswap operate on self-performing algorithms and lack any centralised machinery with head offices, staff, board members, directors, or any personnel who could be held liable for any non-compliance or breach of the procedure.

Third is the transnational friction of jurisdiction, where some Indian users route transactions through offshore platforms that lie outside the reach of the Indian tax regime, as the foreign destination does not maintain any local jurisdictional existence, which leads to great difficulty in tracking the path of flow of the transaction and maintaining a real-time register. While the central government has taken measures like blocking of URLs and offshore mobile accounts and applications by the Ministry of Electronics and Information Technology (MeitY), it can be circumvented through VPNs and similar tools.

6 POLICY SUGGESTIONS

The contemporary Indian tax regime is based on the conventional method of statutory framework, which leads to the phenomenon of Janus Paradox, where the Indian tax regime imposes high tax slabs with a strict compliance mechanism with the objective of promoting the idea of a free and open market for investment. To resolve the issue of the Janus Paradox in the Indian tax regime, there are four key suggestions that should be implemented in the existing statutory framework. First and foremost is the enactment of separate legislation for VDAs, which must define the features of theoretical tokens separately from operational service tokens and also establish a protective statutory framework for the maintenance of users' assets in the event of a breach of security, etc.

Secondly, Parliament should amend the statutory provision of Section 194S³¹ of the Income Tax Act and change the slab of TDS from 1% to 0.01%. A market businessman trades Rs. 1 crore in the market and therefore, according to the current framework, he is liable to pay Rs. 1 lakh, which could somehow deplete the capital from the market. A slab of TDS of 0.01% can give rise to the liability for the market businessman to pay Rs. 1,000, which ultimately protects liquidity in the market, as the businessman could utilize the remaining amount, i.e. Rs. 99,99,000, for further investment in the Indian market, and will also increase the number of investors investing in the Indian market because of lesser TDS slab compared to other countries, which will ultimately increase the overall TDS collection.

Thirdly, intra-class loss offsets must be incorporated in Section 115BBH(2)(b)³² of the Income Tax Act, where if a person profits Rs. 50,000 in token 1 and incurs a loss of Rs. 50,000 in token 2 of the same valuation, then in this case he should be allowed to offset his tax, which is not permitted in the current

³⁰ Prevention of Money Laundering Act 2002 § 17.

³¹ Income Tax Act 1961 § 194S.

³² Income Tax Act 1961 § 115BBH(2)(b).

tax regime, where it violates the doctrine of ability-to-pay by generating a direct cess on monetary-neutral income.

Lastly, section 115BBH(2)³³ of the Income Tax Act should be amended to allow a deduction for the fees of the blockchain algorithm network, where currently it disallows the deduction of mandatory fees for accessing the blockchain system. Consequently, the government should include the supervision of on-chain (blockchain) and other cryptographic networks under FIU-IND, where currently it can only supervise tangible intermediaries.

7 CONCLUSION

The contemporary Indian tax regime is based on the conventional method of statutory framework, which leads to the phenomenon of Janus Paradox, where the Indian tax regime imposes high tax slabs with a strict compliance mechanism to encourage the object of a laissez-faire market for investment. To deal with VDAs as a form of income, the state has taken several measures, such as the imposition of a flat 30% tax on profit, 1% TDS on each transaction, inclusion of VDA service providers in FIU-IND reporting under PMLA, which are somewhat ineffective in properly achieving the objective of a free and open market for investment, which has resulted in the reduction in business quantity in the Indian market by 90%. To deal with the above issue, this paper proposes a reduction in the TDS slab from 1% to 0.01%, allowing for offsets in the event of losses incurred by investors, and lastly, the adoption of on-chain monitoring in the current FIU-IND regime. All the above measures will increase the flow of liquidity as well as the number of investors in the Indian market.

* * *

³³ Income Tax Act 1961 § 115BBH(2).