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Legal, Regulatory and Tax Considerations – Compendium

August 2022

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About NDA

We are an India Centric Global law firm (www.nishithdesai.com) with four offices in India and the only law firm with license to practice Indian law from our Munich, Singapore, Palo Alto and New York offices. We are a firm of specialists and the go-to firm for companies that want to conduct business in India, navigate its complex business regulations and grow. Over 70% of our clients are foreign multinationals and over 84.5% are repeat clients. Our reputation is well regarded for handling complex high value transactions and cross border litigation; that prestige extends to engaging and mentoring the start-up community that we passionately support and encourage. We also enjoy global recognition for our research with an ability to anticipate and address challenges from a strategic, legal and tax perspective in an integrated way. In fact, the framework and standards for the Asset Management industry within India was pioneered by us in the early 1990s, and we continue remain respected industry experts. We are a research based law firm and have set up a first-of-its kind IOT-driven Blue Sky Thinking & Research Campus named Imaginarium AliGunjan (near Mumbai, India), dedicated to exploring the future of law & society. We are consistently ranked at the top as Asia's most innovative law practice by Financial Times. NDA is renowned for its advanced predictive legal practice and constantly conducts original research into emerging areas of the law such as Blockchain, Artificial Intelligence, Designer Babies, Flying Cars, Autonomous vehicles, IOT, AI & Robotics, Medical Devices, Genetic Engineering amongst others and enjoy high credibility in respect of our independent research and assist number of ministries in their policy and regulatory work. The safety and security of our client's information and confidentiality is of paramount importance to us. To this end, we are hugely invested in the latest security systems and technology of military grade. We are a socially conscious law firm and do extensive pro-bono and public policy work. We have significant diversity with female employees in the range of about 49% and many in leadership positions.

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About NDA's FinTech Practice

We have significant experience in the financial services over technology (FinTech) industry since its beginning in India and advise several leading players in the industry as well as industry associations. We have developed expertise and carved a niche in this area through comprehensive research, in-depth understanding and monitoring of the sector. We were the lead firm representing the Internet and Mobile Association of India in its successful Supreme Court challenge to the Reserve Bank of India restriction on virtual currencies, resulting in a first-of-its-kind landmark judgment allowing banks and other regulated entities to facilitate trading in crypto-assets, hence opening up the ecosystem in India. We advise regulated entities in the FinTech industry such as payment aggregators, prepaid payment instrument issuers, other payment system operators, banking partners, cross-border service facilitators, as well other stakeholder entities such as merchants and technology providers on a regular basis. We provide varied services ranging across advisory, disputes and litigation, regulatory and policy initiatives, documentation and transactions assistance. We have closely worked with financial regulators such the RBI and SEBI on obtaining regulatory licenses and setting up regulated business operations, advised our clients on regulatory issues and compliance requirements considering the global outlook of their business, as well as guided them to structure their business and product to the most optimum level while navigating applicable legal compliances effectively. We advise a diverse clientele comprising global MNCs, investment funds, unicorns, startups, intermediaries and service providers with market leading products in industries ranging from the banking, digital media, e-commerce and gaming sectors.

Our experience not only helps us in executing cutting edge matters but also assists in making policy recommendations to the Government of India. We have been involved with industry representative associations such as the Blockchain Association Singapore (BAS), NASSCOM (National Association for Software and Services Companies), DSCI (Data Security Council of India), USIBC (US-India Business Council), IAMAI *(Internet and Mobile Association of India) and FICCI (Federation of Indian Chambers of Commerce & Industry)* amongst others for several years in terms of policy reforms for the IT sector since the early 2000s. We regularly provide feedback on various RBI regulations, provide our recommendations on various draft laws and consultation papers released by different Government ministries, attend open house discussions held by different Government ministries and engaging in dialogue with the regulators seeking clarifications on various grey areas under the law. For instance, we have made representations to the RBI on cyber security framework in the banking sector, alternative solutions to counter restrictions on card data storage requirements such as card-on-file tokenization, drafted self-regulatory code of conduct for the blockchain industry association and drafted an independent policy paper submitted to the Government of India suggesting ways towards the regulation of crypto-assets in India, which we were invited by the Ministry of Finance to present in person.

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1. Digital Payments

August 19, 2021

I. First of its kind outsourcing regulatory framework for payment service providers

A. Background

The Reserve Bank of India (**"RBI"**), India's apex bank recently issued a regulatory framework (**"Framework"**) to be implemented by non-bank payment system operators / providers (**"PSPs"**) for the outsourcing of payment and settlement-related activities to third party service providers. PSPs have been provided with a timeline of until March 31, 2022 to ensure that their outsourcing arrangements comply with the Framework.

B. What is a PSP ?

As per the Payment and Settlement Systems Act, 2007 (**"PSS Act"**), a "payment system" means a *"system that enables payment to be effected between a payer and a beneficiary, involving clearing, payment or settlement service or all of them, but does not include a stock exchange"*.[1] Payment systems include systems enabling credit card operations, debit card operations, smart card operations, money transfer operations or similar operations. An entity that operates a payment system is considered a 'payment system operator' (PSO) or 'payment system provider' (PSP), which needs to be authorized by the RBI. PSPs can include payment aggregators, e-wallet and gift instrument issuers, card issuers and networks, money transfer networks, ATM networks and National Payments Corporation of India (NPCI) that operates the Unified Payments Interface (UPI), a system for fund transfers between bank accounts via a mobile platform.

C. Scope of The Framework

'Outsourcing' under the Framework means use of a third-party service provider to perform activities on a continuing basis that would normally be undertaken by the PSP. 'Service providers' include vendors, payment gateways (PGs), agents, consultants and their representatives engaged in payment and settlement systems activities, including subcontractors or secondary service providers.

The Framework seeks to put in place minimum standards to manage risks involved in outsourcing of payment and settlement-related activities by PSPs, including incidental activities like on-boarding customers, IT services etc.[2] The Framework is applicable to outsourcing of functions by PSPs to service providers in India and overseas.

D. Outsourcing Functions

The PSP should ensure that it exercises due diligence, implements appropriate risk management practices for oversight, and manages risks arising from the outsourcing of activities. Specifically, in terms of critical processes and activities, the Framework requires PSPs to first evaluate the need to outsource such functions based on a comprehensive risk assessment. The outsourcing should not impede or interfere with the ability of the PSP to oversee and manage its activities, nor prevent the RBI from carrying out its supervisory functions. More importantly, the PSP shall continue to be held liable for the actions of its service providers.

1. Section 2(i) of the PSS Act.
2. Though is not applicable to activities not relating to payment / settlement services, such as internal administration, housekeeping or similar activities.

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E. Outsourcing Restrictions

The Framework restricts PSPs from outsourcing 'core management functions' that include risk management, internal audit, compliance and decision-making functions such as determining KYC compliance. 'Core management functions' include management of the payment system operations, transaction management, according sanction to merchants for acquiring, managing customer data, risk management, information technology and information security management.

F. PSP Compliance Framework

The Framework sets out a host of compliance obligations to be fulfilled by the PSP in outsourcing functions to service providers, broadly including the following:

1. **Supervisory Functions:** The PSP would be responsible for the outsourced activity and liable for the actions of its service providers; hence it should retain ultimate control over the outsourced activity.

   a. PSPs should consider all relevant laws, regulations and conditions of regulatory authorization or licenses when outsourcing functions,

   b. Rights of a customer and a participant of payment system against a PSP should not be affected, including grievance redressal,

   c. If the PSP has outsourced its customer grievance redressal function, it should provide its customer the option of direct access to its nodal officers for raising or escalating complaints, and

   d. In cases wherein the customer has an interface with the service provider, the PSP should clearly indicate to the customer the role of the service provider.

2. **Governance:** PSPs should have in place a board-approved comprehensive outsourcing policy setting out amongst other things, criteria for selection of outsourcing activities and service providers, parameters for grading the criticality of outsourcing; delegation of authority depending on risks and criticality; and systems to monitor and review the operation of these activities. In addition,

   a. The Framework sets out the role of the board of the PSP in relation to outsourcing, such as deciding on business activities to be outsourced and approving a framework to evaluate risks and criticality involved in outsourcing.

   b. The Framework further confers responsibilities on senior management of the PSP in relation to evaluating risks and criticality associated with outsourcing functions, ensuring contingency plans are in place and periodically tested and ensuring an independent review and audit for compliance.

   c. All outsourcing arrangements should be maintained in a central record of the PSP, updated and reviewed periodically, and readily accessible to the board and senior management.

   d. The PSP should ensure that the service provider has a robust framework for documenting, maintaining and testing business continuity and recovery procedures arising out of outsourced activities, which should be reviewed and tested periodically by the service provider.

   e. The PSP should consider availability of alternative service providers, and the prospect of bringing back the outsourced activity in-house in case of an emergency.

Furthermore, the Framework restricts a director or officer or their relatives of a PSP in owning or controlling another service provider, unless it is a group company of the PSP.

3. **Outsourcing agreements:** The Framework provides certain requirements for the terms and conditions governing the PSP and their service provider. It should be in writing, reviewed by PSP's legal counsel and address risks and strategies for mitigating risks. The agreement should allow the PSP to retain adequate control over the outsourced activity and the right to intervene when necessary for compliance with law.

   Key provisions of the outsourcing agreement should include:

   a. Defining the activity to be outsourced including service standards,

   b. PSP's access to all books, records and information available with the service provider relevant to the outsourced activity,

   c. PSP's continuous monitoring and assessment of the service provider,

   d. Termination clause and minimum period to execute such provision, if necessary,

   e. Service provider's obligation to ensure controls are in place for maintaining confidentiality of customer data,

   f. Service provider's liability in case of breach of security and leakage of customer information,

   g. Contingency plans to ensure business continuity,

   h. Requirement of PSP's prior approval in case of sub-contracting arrangements,

   i. PSP's audit rights over the service provider,

   j. RBI or RBI authorized persons to access PSP's documents, transaction records and other information stored or processed by the service provider,

   k. RBI's right to inspect the service provider and their books of accounts,

   l. Service provider's obligations to comply with RBI directions involving activities of the PSP,

   m. Service provider's obligation to maintain confidentiality of customer information post expiry or termination of the agreement,

   n. Preservation of documents and data by the service provider and protection of PSP's interests post termination of the outsourcing arrangement.

4. **Confidentiality and Security:** PSP's should ensure that the service provider maintains security and confidentiality of customer information in their custody or possession.

   a. Access to the service provider's staff should be limited and on a 'need to know' basis,

   b. The service provider should not co-mingle and should be able to isolate and identify the PSP's customer information, documents, records and assets to protect confidentiality,

   c. The PSP should regularly review and monitor the security practices and control processed of the service provider,

   d. The service provider should report security breaches to the PSP,

e. The PSP should report to the RBI any security breaches and customer confidential information leakages. Liability to customers for such breaches would lie with the PSP.

f. PSPs should ensure that the service provider, whether domestic or offshore, adheres to the RBI's instructions on storage of payment system data.

G. Outsourcing Within Group / Conglomerate Entities

The Framework specifically address PSP's having service arrangements with group entities; for instance, legal and professional services, IT applications, back-office functions, outsourcing payment and settlement services etc. Such arrangements should be based on the PSP's board approved policy and service level arrangements with its group entities.

PSP's should ensure that:

1. The agreements cover demarcation of shared resources like premises, personnel etc.,
2. In case of multiple group entities cross-selling, customers should be informed about the actual entity offering the product or service,
3. The agreements should be in writing and cover details like scope of services, charges and confidentiality of customer data,
4. The arrangement should not cause confusion among customers, as to whose products or services they are availing, by clear physical demarcation of the site of activities of different group entities,
5. The arrangements should not compromise the ability of the PSP to identify and manage risks on a standalone basis,
6. The arrangements should not prevent RBI from obtaining information required for supervision of the PSP or to the group as a whole,
7. The PSP's ability to carry out operations in a sound fashion is not affected if premises or other services like IT or support staff services provided by the group entity are interrupted,
8. Risk management practices adopted by PSP's for outsourcing to group entities should be the same as prescribed in the Framework for a non-related party.

H. Outsourcing to Oversea Sentities

The PSP should monitor Government policies, political, social, economic and legal conditions in countries where the service provider is based, both during the risk assessment process and on a continuous basis. Contingency and exit strategies should be in place.

In outsourcing services relating to Indian operations to offshore entities, the PSP should ensure that:

1. In principle, arrangements should be with parties in jurisdictions that generally uphold confidentiality clauses and agreements,
2. The governing law of the agreement is clearly specified,

3. The activities outsourced should be conducted in a manner to not hinder efforts to supervise or reconstruct the India activities of the PSP,

4. The offshore regulator should not obstruct to the arrangement nor object to RBI's visits for audit, scrutiny, examination, inspection, assessment or visits from PSP's internal and external auditors,

5. The offshore regulator does not have access to the data relating to the PSP's India operations, and

6. The jurisdiction of courts in the offshore jurisdiction does not extend to the PSP's operations in India merely because data is processed in the offshore location.

I. Participants in The Payments Ecosystem

The PSP should also engage with all participants in a payment transaction to encourage them to implement the Framework. Specifically, in respect of payment systems operated by PSPs involving other participants such as token requestors in tokenization solutions, third-party application providers in UPI systems etc. who may not be directly regulated or supervised by RBI; but it is prudent for such participants to put in place systems to manage risks arising out of activities outsourced by them.

The above provisions from the Framework do not appear to relate per se to outsourcing activities, though appear to suggest that non-licensed entities in the payment's ecosystem are encouraged to adopt appropriate security and risk mitigation measures.

J. Analysis

Firstly, payment intermediaries were historically not directly regulated by the RBI but instead since 2009, were indirectly via AD banks with whom they needed to have nodal accounts for settlement of transactions between merchants and consumers. In a paradigm shift since March 2020, payment intermediaries that handle the funds, in receiving, pooling and transferring funds from customers to merchants were directly regulated and put under a licensing regime by the RBI. This was the first step to regulating payment aggregators, a type of a PSP.

However, certain other PSPs were and continue to be regulated under the PSS Act and RBI regulations, for instance, e-wallet and gift instrument issuers. In fact, PSPs are being drawn a wider net of regulation in recent years, given the important role that they play in payment transactions, for instance imposition of data localization norms. Having said that, outsourcing functions of PSPs were not previously regulated, unlike in the case of banking and non-banking financial companies (NBFCs) wherein specific RBI directives were issued on the subject. Hence, this is a first of its kind regulation for outsourcing functions of PSPs.

Secondly, the Framework doesn't substantially differ from the previous RBI directives on outsourcing applicable to banks and NBFCs which also contained provisions along the same lines such as control and supervision, risk assessments and policies, confidentiality and security, outsourcing agreements, outsourcing restrictions, grievance redressal and outsourcing within group entities / conglomerates, and to offshore service providers. Hence, whilst the Framework is a first for PSPs, it appears to only follow precedent that the RBI has set in regulating outsourcing functions by regulated entities, though more sophisticated. This entails that PSPs would follow the route taken by banks and NBFCs in terms of governance and contractual compliances when outsourcing functions to service providers.

Thirdly, the Framework restricts outsourcing of 'core management functions', which includes some of the obvious functions meant to be carried out directly by the PSP such as management of payment system operations, transactions and risk management, audits, compliance and decision-making functions. However, managing

customer data and IT and InfoSec management is also considered a 'core management function' that cannot be outsourced. Further, customer data is defined to include payments-related data / information.

Basis this and considering the recent data storage restrictions, it will be interesting to see how the industry views "management" especially in the context where data storage / processing functions are outsourced but the PSP continues to retain overall control / rights over the data. In such situations it would need to be evaluated whether the same would be viewed as outsourcing of a core management function.

Similarly, it is common for banks, NBFCs and even PSPs to engage service providers for IT and InfoSec services and to provide systems and solutions for the former's business operations. Such arrangements would also need to be evaluated to determine whether it constitutes outsourcing of 'management' functions.

Also, the Framework identifies 'core management functions' in a non-exhaustive manner by using the term "including". Thus, unless clarified by the RBI, it would always be subjective and open to interpretation on what other functions would be deemed to be 'core management functions' which should not be outsourced by PSPs.

Finally, from a cross-border perspective, PSPs would need to evaluate existing and future arrangements keeping in mind additional requirements. Requirements for the PSP to ensure that the offshore regulator does not object to RBI/PSP's visits and audits and does not access the data to the PSP's India operations and offshore Courts' jurisdiction does not extend to PSP's operations in India; go beyond the offshore outsourcing provisions applicable to banks and NBFCs. PSPs would need to implement extra steps and assessments which may include understanding and taking legal opinions on applicable foreign laws prior to entering into such offshore outsourcing arrangements, as well as tailor the outsourcing agreements to address the cross-border requirements.

K. Conclusion

From a user perspective, this Framework is a welcome step where non-bank PSPs would be subject to outsourcing compliances which would largely benefit consumer interest. This is also in line with the existing outsourcing regulations as applicable to banking and non-banking financial companies. However, given the advancements in technology and security solutions along with business prowess of new fintech players including PSPs, outsourcing certain activities relating to managing customer data, IT services and InfoSec functions should be permitted subject to relevant compliances under the Framework.

Consumer interests could still be protected as PSPs would need to comply with the Framework including implementation of risk evaluation policies, security standards, audits, controls and stringent contractual arrangements with third party service providers. Thus, categorizing the said activities as 'core management functions' which cannot be outsourced may impact the growth and innovation of the industry.

– Aaron Kamath & Huzefa Tavawalla

January 28, 2021

II. India's Booming Fintech Set For Self-Regulation

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The Reserve Bank of India (**"RBI"**), India's apex bank conferred with legislative powers, published[3] a Framework for Recognition of a Self-Regulatory Organization for Payment System Operators (**"Framework"**)[4]. This comes at a juncture where the Indian digital payments industry is witnessing increasing innovation, disruption and velocity. This is not the first self-regulatory mechanism that is being introduced by the RBI as it previously established a self-regulatory framework for non-banking financial companies offering various products in micro-finance (**"NBFC-MFIs"**) in 2013.[5]

In February 2020, the RBI published a Statement on Developmental and Regulatory Policies[6] expressing its intent to further boost the industry and encourage the establishment of self-regulatory organizations (**"SROs"**) for Payment System Operators (**"PSOs"**)[7]. In line with this vision of self-governance, the Framework has followed suit.

As the number of players in the payment ecosystem increase steadily, RBI has sought to optimize regulatory resources available and promote self-regulation in terms of pricing mechanisms, security standards, customer protection measures, behavioral and ethical standards, and grievance redressal. The Framework establishes a system to provide formal recognition to associations formed between the industry players to set certain standards of business for and between themselves. The Framework details the criteria of recognition of such bodies, their functions and the oversight of the RBI over their functioning.

A. Concept of SROs

The Framework envisages recognition of SROs which are established as autonomous organizations. These SROs are intended to be set up by mutual agreement of members who would enter into respective membership agreements with the SRO. The membership agreements provide a basis for an SRO's authority and allows it to set standards, procedures, oversight mechanisms and resolve conflicts between members.

The SRO's responsibility, while taking into consideration vested interests, would be to devise behavioral and professional standards that address larger interests of the ecosystem such as to impart training to staff of its members, conduct awareness programs, and promote research and development. An SRO is also expected to have a well-defined and transparent means of conflict resolution, and an effective system of monitoring and enforcement.

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3. Published on January 19, 2021.
4. Available at: https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=11986&Mode=0. Last accessed: January 19, 2021.
5. https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=30052. Last accessed: January 19, 2021.
6. Available at: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=49343. Last accessed: January 19, 2021.
7. A Payment System is defined as a system that enables payment to be effected between a payer and a beneficiary, involving clearing, payment or settlement service or all of them (not including a stock exchange) under section 2(i) and Payment System Operators are persons who operate an authorized payment system or participate in a payment system as provided under sections 2(p) and 2(q) of the Payment and Settlement Systems Act, 2007.

B. Regulator's Recognition

The RBI grants formal recognition to SROs which meet the prescribed eligibility criteria. An SRO:

- must be set up as a non-profit company under the Companies Act, 2013;
- must have clear bye-laws that sufficiently establish the procedure of obtaining membership and define the manner of the SROs' functioning i.e. the board of directors;
- must have only regulated payment system entities, such as banks and non-bank PSOs as members; and
- must have a uniform, reasonable fee for its members and must be financially self-sufficient to discharge its responsibilities.

An SRO is governed by a board of directors who must meet a prescribed 'fit and proper' criteria. At least one-third of the board members must be independent and not associated with member institutions and any change or an adverse development about any Director must be informed to the RBI. The board must devise a member code of conduct. The RBI can also mandate that the appointment of important positions in the board of directors of an SRO be done only upon its approval, if it so sees fit. It may revoke the recognition granted to the SRO too if it deems the functioning of an SRO to be detrimental to public interest.

C. Role of SROs

An SRO is intended to embody the representation of the common will of the stakeholders in the digital payments industry. It is managed by a board which is governed by its own code of conduct and decides how the SRO functions. The SRO is expected to perform typical regulatory duties such as:

- establish minimum professional, behavioral and ethical standards for its members and act as a catalyst for a competitive but fair market;
- inform the RBI of the violation of either the Payments and Settlement Systems Act, 2007 or any other circular, direction or regulation notified by the RBI;
- establish a uniform grievance redressal and conflict resolution system for the benefit of all its members, including inter-PSO issues;
- train its members and spread awareness about safe payment transactions;
- work in coordination with the RBI for the larger interest of the industry and comply with any directions issued by the RBI including the terms of its recognition; •work in coordination with the RBI for the larger interest of the industry and comply with any directions issued by the RBI including the terms of its recognition;
- play a constructive role in supplementing and complementing existing regulatory / supervisory arrangements; and
- have completely transparent processes of functioning in place and be in a position to monitor the effective implementation of codes of conduct and regulations.

D. Foundation Stone for Self-Regulation

The introduction of a self-regulatory framework by the RBI bodes well with the Government of India's policy of minimum government, maximum governance. While the Framework is a progressive step towards the growth of the industry, it is important for the RBI to supplement it further. Future guidance from the RBI in the form of model codes/rules, checklists, etc. would go a long way in creating a robust system of self-regulation including ethical and behavioral standards, and an effective mechanism of conflict resolution. While the Framework is a welcome move, it does pose some interesting questions.

Firstly, the Framework allows only banks and non-bank PSOs to be members of an SRO and overlooks the fact that there are other stakeholders in the industry who form a vital part of the payments ecosystem including unlicensed entities offering a variety of fintech products to consumers, backend technology providers, merchants and consumers and consumer associations. Recognized self-regulators in other jurisdictions such as the Australian Payments Network (**"AusPayNet"**)[8], the Financial Industry Regulatory Authority[9] in the USA and the Investment Industry Regulatory Organization of Canada[10] allow both regulated and non-regulated entities to join as its members. Closer to home, bodies such as the Advertising and Standards Council of India (**"ASCI"**)[11], the Indian Broadcasting Foundation (**"IBF"**),[12] and the Payments Council of India[13] allow both regulated and non-regulated entities as members. It is important to recognize that fintech companies of the day are more diverse and disruptive than traditional banking or other financial companies and hence, representation of from various stakeholders becomes even more crucial. The Framework must provide such entities an adequate degree of representation in these SROs to truly do justice to its purposes.

Secondly, the Framework requires that an SRO must be a 'not-for-profit company' but the rationale for such a requirement is unclear. It must be noted that many SROs such as the Microfinance Institutions Network[14] and Sa-Dhan[15] (both of which are registered under RBI's SRO scheme for NBFC-MFIs), and the Internet and Mobile Association of India are registered societies and not incorporated companies. Such an obligation in the Framework would add additional burden since registered companies have comparatively more compliance obligations than a registered society such as conducting a minimum number of board meetings in a year and annual filing requirements. Notably, the Payments Council of India and the Indian Banks Association are in talks to set up a non-profit entity and apply for recognition under the Framework.[16]

Thirdly, the degree of oversight the Framework provides to the RBI may result in over-intervention into the functioning of an SRO. The Framework allows RBI to ensure that an SRO takes its approval for appointment of important positions to its board of directors, if necessary. An SRO's recognition may be withdrawn if the RBI opines that it is functioning in a manner detrimental to the public interest. Other self-regulatory organizations in India i.e. ASCI and the IBF hold more autonomy in the manner of appointment of management personnel and general functioning. The RBI should be wary of turning a self-regulatory framework into a pseudo-regulatory framework.

8. Available at: https://www.auspaynet.com.au/join-us. Last accessed: January 19, 2021.
9. Available at: https://www.finra.org/registration-exams-ce/registration. Last accessed: January 19, 2021.
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15. Available at: http://www.sa-dhan.net/wp-content/uploads/2020/12/Information-Brochure.pdf. Last accessed: January 19, 2021.
16. Available at: https://economictimes.indiatimes.com/tech/technology/lobby-groups-iba-pci-in-talks-to-set-up-regulatory-body-for-digital-payments/articleshow/79022443.cms. Last accessed: January 19, 2021.

Fourthly, the Framework is unclear on whether it seeks to recognize a single SRO for the payments ecosystem (or group of banks or PSOs) or if it would allow establishment of multiple SROs. While para 1.3[17] of the Framework provides that the establishment of an SRO would be encouraged, there is no express prohibition across the Framework on different associations of banks and non-bank PSOs from forming their own SROs, thereby multiple SROs. Establishing a single SRO may potentially defeat the purpose of self-regulation as it may lead to the formation of a shadow or pseudo regulator which would function at the pleasure of the RBI.

Lastly, the most typical observation on any self-regulatory mechanism across industries is the efficacy of its dispute resolution and penal framework. Enforceability is also a prime objective of the Framework and the SRO seems to lack teeth in this aspect. While an SRO is bound to notify any violation of laws to the RBI, it appears that it cannot itself impose penalties or other mechanisms of enforceability on its members except contractually through its membership agreements. There exists a possibility that a member may choose to forfeit the membership of the SRO at the imposition of an undesirable enforceability action and that would adversely affect the SRO itself and perhaps the industry group as a consequence. The Framework provides that an SRO also gets legitimacy by the efficiency with which self-regulation is perceived to be administered. A possible solution would be have a penal referral mechanism in place where an SRO can refer violations by its members to the RBI in the event they refuse compliance and recommend penal action by the regulator. The ASCI has the power to issue notices to industry players in case of violations as well as the power to send recommendations to the Ministry of Information and Broadcasting in case of non-compliance of its members.

- **Aaron Kamath, Purushotham Kittane and Vaibhav Parikh**

17. **Para 1.3 of the Framework:** *It has, therefore, been decided to encourage the establishment of a Self-Regulatory Organisation (SRO) for Payment Systems Operators (PSOs).*

March 24, 2020

III. Licensing Regime Introduced For Payment Aggregators: E-Commerce Industry To Undergo Significant Change

The Reserve Bank of India (**"RBI"**), India's central and apex bank on March 17, 2020 issued detailed guidelines[18] (**"Guidelines"**) applicable to payment aggregators (**"PAs"**), which shall come into effect from April 1, 2020.

Going forward PAs will need to an authorization / license to operate from the RBI. No authorization /license is prescribed for payment gateways (**"PGs"**). While Guidelines recommend certain good practices for PGs, they are not mandatory. Since 2009, RBI regulated entities who were facilitating payments between users and merchants using any electronic / online payment mode, via intermediary directions dated November 24, 2009[19] (**"Intermediary Directions"**).

The RBI had earlier in September last year floated a discussion paper[20] (**"Discussion Paper"**) wherein it was exploring regulating PAs and PGs, given that they form a critical link in the online world of commerce. Some key concerns raised by the RBI in the Discussion Paper were:

i. The activities of PAs and PGs in online transactions are extremely crucial and such entities may be a source of risk, if they have inadequate governance practices that may impact customer confidence and experience.

ii. A customer has very limited recourse to PAs and PGs and must rely on merchants or banks who in turn seek redressal from the PAs.

iii. Being part of the payments process chain, these entities also handle sensitive customer data. Hence, managing customer data, data privacy and know-your-customer (KYC) requirements of merchants are important from a security and customer confidence perspective.

Basis the above, it appears that the Discussion Paper paved the way for the said Guidelines. For ease of reference, we have sought to break down the Guidelines in a Q&A format as detailed below.

A. What are PAs And PGs?

The Guidelines define 'payment aggregators' as *"entities that facilitate e-commerce sites and merchants to accept various payment instruments from the customers for completion of their payment obligations without the need for merchants to create a separate payment integration system of their own. PAs facilitate merchants to connect with acquirers. In the process, they receive payments from customers, pool and transfer them on to the merchants after a time period."* Thus, PAs are those entities that facilitate payments to merchants, and that receive, pool and transfer user payments to the merchants as part of the facilitation process.

On the other hand, 'payment gateways' are defined as *"entities that provide technology infrastructure to route and facilitate processing of an online payment transaction without any involvement in handling of funds."* Thus, PGs under the Guidelines may be limited to entities providing authentication services, back-end infrastructure or technology integrations services which assist in the payment ecosystem.

18. Available at: https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11822&Mode=0 Last accessed: March 19, 2020
19. Available at: https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=5379&Mode=0 Last accessed: March 19, 2020.
20. Available at: https://m.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=943 Last accessed: March 19, 2020.

However, this understanding would need to be further examined basis the existing law on intermediaries (as discussed in the below Q&A).

B. Who Does The Guidelines Extend to?

The Guidelines are specifically applicable to PAs, though there are also recommended good practices (non-binding) for PGs, such as security and data retention related measures. The Guidelines even apply to domestic legs of import and export related payments facilitated by PAs.

The Guidelines do not apply to cash-on-delivery e-commerce models.

C. When do The Guidelines Become Effective?

Any new entity that intends to offer the services of a PA post April 1, 2020, would be subject to the said Guidelines. Thus, with effect from April 1, 2020 any new entity intending to provide PA services can only do so post authorization from the RBI.

For existing PAs, they need to apply for RBI authorization on or before June 30, 2021 and then they would be allowed to continue operations until they hear back from the RBI on their application. However, it appears unclear from the Guidelines that until such authorization has been obtained by existing PAs, whether such PAs would continue operating as per the Intermediary Directions or adopt measures and compliances under the Guidelines.

This is an aspect that requires further clarity from the regulators.

D. What is The Inter Play Between PAs and Intermediaries?

As per the Intermediary Directions, intermediaries were defined as: "all entities that collect monies received from customers for payment to merchants using any electronic/online payment mode, for goods and services availed by them and subsequently facilitate the transfer of these monies to the merchants in final settlement of the obligations of the paying customers."

The said Intermediary Directions also stipulated compliances involving use of nodal accounts, permissible debits / credits in such nodal accounts, time periods for final settlement of funds to merchants etc. However, as per the said Intermediary Directions, entities operating as intermediaries were not required to obtain an authorization / license from the RBI for undertaking the said activities.

On the other hand, PAs under the said Guidelines appear to be a sub-set of an intermediary as they also facilitate transactions between users and merchants by pooling funds and transferring them to merchants. Thus, the question which arises is would there be any intermediaries (as per the Intermediary Directions) which would not be categorized as PAs under the said Guidelines, and if so, how would such intermediaries continue to be treated. Going by the intent, it seems that the Intermediary Directions would be phased out once the Guidelines are fully into effect.

E. What are The Key Eligibility Criteria for A PA to Obtain RBI Authorization?

i. **Authorization** – Bank PAs do not need separate authorization from RBI. Non-bank PAs are required to seek an authorization from RBI. Only a company (as opposed to other types of entities) is eligible to register as a non-bank PA. An LLP would not be eligible for such RBI authorization.

ii. **Marketplaces:** E-commerce marketplaces providing PA services cannot continue the said activity beyond June 30, 2021. If they desire to do so, the PA services will have to be separated from the marketplace business and then an application for authorization as a PA will need to be made on or before June 30, 2021. Such internal restructuring could lead to significant tax & contractual issues which will need to be evaluated on a case to case basis.

iii. **Capital Requirements** - Existing PAs are to have a net-worth of INR 15,00,00,000 (approx. USD 2,000,000) by March 31, 2021 and net-worth of INR 25,00,00,00 (approx. USD 3,330,000) by the end of the 3rd financial year, i.e. on or before March 31, 2023. This net-worth should be maintained at all times thereafter.

New PAs should have a minimum net-worth of INR 15,00,00,000 (approx. USD 2,000,000) at the time of filing its application for RBI authorization and should attain a net-worth of INR 25,00,00,000 (approx. USD 3,330,000) by the end of the 3rd financial year from the grant of authorization. This net-worth should be maintained at all times thereafter.

F. What is The Role That PAs Will Play in Settlement of Transactions Going Forward?

Unlike as prescribed under the Intermediary Directions wherein intermediaries are required to open a nodal account, the Guidelines prescribe that a non-bank PA maintain an escrow account with any one scheduled commercial bank for amounts collected, which the PA may also pre-fund. The escrow account cannot be used for or co-mingled with other businesses, if any, of the PA. The amounts held in the escrow account should be interest free, except under certain circumstances as maybe determined between the PA and bank.

Once the amount is deducted from a user's account, it should be remitted to the escrow account on a 'T'+0 or 'T'+1 basis. Thereafter, final settlement with the merchant may take place as follows:

- If the PA is responsible for the delivery of goods / services – 'T'+1 basis wherein T is the date of intimation by the merchant to the intermediary about the shipment of goods.
- If the merchant is responsible for delivery – 'T'+1 basis wherein T is the date of confirmation by the merchant to the PA about the delivery of goods
- If the agreement provides for the PA to keep the amount till expiry of refund period – 'T'+1 basis where T is the date of expiry of the refund period fixed by the merchant.

The escrow account should also be used to route credits towards reversed transactions and refunds.

Similar to that of a nodal account, the escrow account to be opened by PAs allows for only certain credits and debits,as follows:

i. Credits

a. Payment from various customers towards purchase of goods / services.

b. Pre-funding by merchants / PAs.

c. Transfer representing refunds for failed / disputed / returned / cancelled transactions.

d. Payment received for onward transfer to merchants under promotional activities, incentives, cash-backs etc.

ii. Debits

a. Payment to various merchants / service providers.

b. Payment to any other account on specific directions from the merchant.

c. Transfer representing refunds for failed / disputed transactions.

d. Payment of commission to the intermediaries. This amount shall be at pre-determined rates / frequency.

e. Payment of amount received under promotional activities, incentives, cash-backs, etc.

G. What are The Key Compliances Applicable to PAs?

i. **Technology** – The PA should have a board approved policy for information security for the safety and security of the payment systems operated and such measures should be implemented. A PA should put in place adequate information and data security infrastructure and systems to prevent and detect fraud, and other **technology based recommendations** as provided in the Guidelines.

ii. **Governance** – The promoters of the PA entity should satisfy a 'fit and proper' criteria prescribed by the RBI and the directors are to submit an undertaking as per the prescribed format. A PA should have a board approved policy for disposal of complaints / dispute resolution mechanism and time-lines for processing refunds etc. as per timelines prescribed by the RBI. A nodal officer should also be designated for regulatory functions and to handle customer complaints as well as an escalation matrix.

In terms of documentation, a PA should have (i) agreements in place with merchants, acquiring banks and other stakeholders that delineate the roles and responsibilities of each party in handling complaints, refunds, returns, customer grievances, dispute resolution and reconciliation, and (ii) disclosure comprehensive information regarding merchant policies, customer grievances, privacy policy and other terms and conditions on its website / application.

Furthermore, any takeover or acquisition of control of change in management of a non-bank PA should be communicated to the RBI within 15 days. Although not explicit, it appears that this reporting requirement triggers post the corporate action taking place. However, given the ambiguity, it may be preferable to notify the RBI prior to such corporate action, given that the Guidelines give discretion to RBI to place restrictions on such changes, if deemed suitable.

iii. **Merchant on-boarding** - A PA should have a board approved policy for merchant on-boarding. In addition, the PA should conduct background and antecedent checks on the merchant to ensure that they do not have a history of duping customers or selling fake / counterfeit / prohibited products.

iv. **KYC** – The Guidelines also make prevailing KYC norms applicable to PAs. Though unclear, it appears that PAs and PGs should conduct KYC checks on its customers, which may be merchants and / or end users, basis the nature of each arrangement. Generally, this KYC requirement should apply only to PAs vis-à-vis the merchants since the merchants are considered customers of the PA and have a direct contractual arrangement with such PAs. However, further clarity on the same by the RBI would be helpful.

v. **Security and Data** – The Guidelines also prescribe certain security, fraud prevention and risk management compliances for PAs, in terms of policies to adopt and measures to implement. Specifically, PAs should not store customer card credentials on their systems that may be accessed by the merchant. PA's would also be subject to the data storage requirements applicable to payment system operators, which appear to also

include data localization requirements in terms of end-to-end transaction data.[21] Hence, such data would not be able to be transferred outside India, unless in certain circumstances and subject to certain compliances.

There is also a requirement for PAs to take preventive measures to ensure that data is stored in *'infrastructure that does not belong to external jurisdictions'*. This requirement of data sovereignty appears vague and unclear. Situations where an Indian company (which is a wholly owned subsidiary of a foreign company) or any other Indian owned / controlled entity using foreign technology to provide data storage services to PAs would need to evaluate whether they fulfil the necessary data compliance requirements.

H. Conclusion

It appears that many of the prescribed compliances as per the Guidelines are similar to those already prescribed by the RBI for payment system operators, such as e-wallet and gift card issuers, and it appears that the RBI is placing PAs on the same pedestal as such payment system providers in terms of regulation.

Also, the obligations placed on PAs vis-à-vis merchants such as conducting background checks on the merchant's history to ensure that they do not have a history of duping customers or selling fake / counterfeit / prohibited products, appears onerous and practically difficult to implement. Although one could consider evaluating self-declarations made by merchants in this regard.

These Guidelines also bring about multiple uncertainties, such as the fate of intermediaries that do not constitute PAs and how would they continue to function, especially since these Guidelines do not specifically repeal nor clarify to what extent it would override the Intermediary Directions.

Furthermore, as previously mentioned, the Guidelines are also unclear on the position and approach that existing PAs should take prior to obtaining an authorization, i.e. whether they should continue to comply with the Intermediary Directions or comply with the Guidelines by April 1, 2020.

Given that the Guidelines propose to bring about significant changes in the e-commerce industry and would change the way online payments are structured, it may be helpful if the RBI were to issue FAQs of its own, throwing light on various uncertainties and clearly explaining the position going forward for intermediaries and PAs.

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21. Read our write-up on the data localization requirements applicable to payment system operators here.

January 18, 2022

IV. No Internet? No Problem, as Indian regulator enables offline digital payment

A. Background

In a significant boost for offline digital transactions, the Reserve Bank of India (RBI) has released a framework[22] for facilitating small value digital payments in offline mode. An 'offline digital payment' is a transaction that does not require the internet or telecom connectivity. The framework, effective from January 3, 2022 is expected to boost digital transactions in areas with no or poor internet or telecom connectivity, particularly in semi-urban and rural areas in India.

As per the RBI's '*Statement on Developmental and Regulatory Policies*'[23], three pilots were successfully conducted in different parts of India to test small-value transactions. Based on the feedback, the RBI thought it fit to introduce such solutions and a framework suitable for conducting retail digital payments in offline mode throughout India. This is the first framework of its kind to enable digital payments sans the internet.

B. Framework

Authorized payment system operators, payment system participants and banks that are interested to provide or enable such payment solutions for their users may facilitate small value digital payments as per the following criteria:

1. The framework applies to payments made face-to-face (in proximity) using any mode or instrument like cards, ewallets, mobile devices etc.

2. Offline payments may be made subject to a limit of INR 200 (approx. USD 3) per transaction and an overall limit of INR 2,000 (approx. USD 30) for all offline transactions. The user limit may be replenished only through online mode.

3. Such transactions require user consent, though no additional factor of authentication is required such as a pin or one-time-password sent to the user's email address or phone number.

4. Users are entitled to similar protection against customer liability in case of fraudulent / unauthorized transactions and grievance redressal, as for regular electronic banking transactions.

5. Transaction alerts may be sent to the user after a time-lag, and though not necessary to be sent for each transaction, when sent they should provide details of each previous transaction.

6. The acquirer should absorb liabilities arising from any technical or transaction security issues at the merchant's end.

22. Available at: https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12215&Mode=0. (Last accessed: January 15, 2022).
23. Available at: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=52368. (Last accessed: January 15, 2022).

C. Analysis

Boost for digital payments

In a sector which saw about 6 billion debit and credit card transactions at an amount of USD 174 billion and almost 5 billion prepaid instrument transactions (e-wallets, gift cards etc.) at an amount of USD 27 billion in FY 2020-21,[24] enabling digital payments in an offline mode is set to significantly boost digital payments in the country. Though the new framework may not have a significant impact on digital payments in metro or tier one cities in India, it should in the semi-urban and rural parts of India. Though telecom and internet connectivity in semi-urban and rural India is picking up, there is still some catching up to do. For instance, the Union Minister for Electronics, IT and Communication stated in Parliament in March 2021 that 25,067 villages in India lack mobile and internet connectivity.[25] In such places, the framework proposes to have a huge impact as it would enable people to transact in person through their cards, e-wallets and mobile without internet connections.

Pilot testing a welcome step

It is a welcome and encouraging takeaway that the RBI had tested the proposed solutions through three pilot programs conducted over the course of about a year in different parts of India. Basis the feedback, the RBI thought it prudent to roll out the framework. This appears a well-planned and thought-out approach and sets a precedent for RBI and an example for other industry regulators to consider piloting proposed product and technology solutions before issuing enabling framework for its implementation in the sector.

Infrastructure considerations

The framework appears clear on the compliance requirements and criteria for implementation of the framework by banks and payment system operators. The RBI has not mandated specific technological solutions. Presumably, this may be left to the industry players to develop, test and deploy relevant product solutions to enable their users to transact in offline mode.

We would need to watch for instance, whether debit cards currently in use can be used for offline payments; or whether fresh debit cards would need to be issued that would be compliant for use in offline mode. For instance, cards with specific radio frequency identification (RFID) technology were issued to make them compliant for nearfield communication (NFC) contactless payments.

Reference to mobile device is interesting as one of the possible solutions. Banks and payment service providers may work out some solutions of embedded software with device companies. Banks, payment service providers and perhaps card networks may need to discuss and work with telecom and internet service providers on aspects such as processing payments through point-of-sale (PoS) terminals, mobile devices etc. either with or in the absence of network, and communicating transaction alerts to the user upon the user receiving connectivity.

Implementation uncertainties

The framework is left to the banks and payment system operators to implement, at their 'desire' and is not a mandatory obligation placed on them. Given recent trends, for instance the new recurring payments e-mandate registration framework that took effect in October 1, 2021 (after multiple extensions), banks have been slow in developing and deploying technology solutions and infrastructure, and may also take a backseat in implementing offline payments for their users, especially if not adequately incentivised. It would be interesting to observe if RBI

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24. Source: https://www.rbi.org.in/Scripts/BS_ViewBulletin.aspx?Id=20737. (Last accessed: January 16, 2022).
25. See: https://www.thequint.com/news/hot-news/25067-villages-in-india-lack-internet-connectivity-prasad-in-ls. (Last accessed: January 15, 2022).

continues the push for offline payments and ultimately mandates the banks and payment system operators to implement the framework.

Kirana shops the winner

In a world increasingly dominated by the internet and e-commerce, this step appears to benefit the **'kirana'** shops or local family-run shops, grocers and vendors the most. With an abundance of them in semi-urban and rural India where mobile data and internet connectivity may be infrequent, low or absent, footfall at such shops are bound to increase if consumers can transact through their card, mobile or e-wallet in offline mode for small value purchases like household items and groceries.

The framework may also benefit local merchants and vendors in such regions that facilitate low value mobile recharges, lottery ticket sales, wallet reloading and sale of gaming or content related vouchers. Such transactions, that may typically be settled in cash by the consumer, could be done offline via the user's card, e-wallet or mobile device.

– **Aaron Kamath & Gowree Gokhale**

December 6, 2021

V. Regulations on E-Wallets, Gift Cards and Vouchers Given a Facelift

A. Introduction

In a significant update, the Reserve Bank of India (**"RBI"**) released the Reserve Bank of India Master Directions on Prepaid Payment Instruments, 2021 (**"PPI Regulations"**)[26] in August, 2021. The PPI Regulations subsume the Reserve Bank of India (Issuance and Operation of Prepaid Payment Instruments) Directions, 2017 (**"2017 Regulations"**)[27] with immediate effect, and also consolidate various circulars on pre-paid instruments (**"PPIs"**) that had been issued between 2017 and 2021. These regulations are issued by the RBI under the Payment and Settlement Systems Act, 2007.[28]

More commonly referred to as 'e-wallets' or 'gift cards', PPIs are payment instruments that can be used for the purchase of goods or services against this stored value. The PPI Regulations impact products such as e-wallets, gift cards and vouchers, money transfer wallets, meal vouchers, metro/travel rail cards, etc. Where the 2017 Regulations allowed paper PPIs in the limited instance of prepaid paper meal vouchers (Sodexo being the best example), the PPI Regulations do not allow any form of paper PPIs.

B. Key Aspects Of The PPI Regime

Important aspects of the now consolidated PPI regime are as follows:

i. Closed System PPIs Not Regulated by RBI

The 2017 Regulations classified PPIs into Closed System PPIs (used to facilitate the purchase of goods and services from that entity only), Semi Closed PPIs (used for purchase of goods and services, including financial services, remittance facilities, etc., at a group of clearly identified merchant locations),and Open PPIs (issued only by banks and are used at any merchant).

The PPI Regulations retain the classification of Closed System PPIs and clarify that "the issuance or operation of such instruments is not classified as a payment system requiring approval / authorization by RBI and are, therefore, not regulated or supervised by RBI". This clarity will be welcomed by the industry as there existed divergent views on whether Closed System PPIs were required to comply with the terms of the 2017 Regulations even though they did not require authorization. Therefore, Closed System PPIs, i.e. any PPIs that are issued and redeemed by the same entity are not regulated by the RBI, and do not need to seek authorization to be offered.

ii. Introduction of Small and Full PPIs

Where Closed System PPIs are issued and redeemed by the same entity, there are numerous PPIbusiness models that allow the onboarding of third-party merchants with whom the value stored on thePPI may be redeemed. Such PPIs require authorization from the RBI before they are allowed to operate,and are of the below five categories. The RBI has replaced the erstwhile classification of 'Semi-Closed'and 'Open' PPIs with 'Small' PPIs and 'Full KYC' PPIs.

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26. https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12156 (last accessed November 30, 2021).
27. You may refer to our analysis on the 2017 Regulations here.
28. The PPI Regulations are issued under Section 18 read with Section 10(2) of the Payment and Settlement Systems Act, 2007.

1.Digital Payments

The below five categories of PPIs are:

Sl. no	Features	Small PPI (with cash loading)	Small PPI (without cash loading)	Full KYC	Gift Cards	Mass Transit System (MTS)
1.	Purpose	Only for purchase of goods and services at a group of identified merchants/ establishments		Can be used for purchase of goods and services (across multiple merchants), funds transfer or cash withdrawal.	Can be purchased by a person and redeemed by another person with a group of identified merchants/ establishments.	May be used at mass transit systems for fare collection, and merchant outlets whose activities carried on within premises of the MTS.
2.	KYC required / user details to be collected	Minimum details - mobile number (verified by OTP), selfdeclaration of name, identification number of any 'mandatory document' or another recognised official document.[29]		Authentication of the user to be completed as per RBI mandated regulations.[30]	Authentication of the purchaser to be completed as is done for Small PPI.	As decided by the Issuer.
3.	Conversion	Shall be converted into full- KYC PPIs within 24 months from the date of issue, failing which, no further credits permitted.	N/A	N/A	N/A	N/A
4.	Reloadability	Shall be reloadable and issued only in electronic form. Can be reloaded via cash.	Shall be reloadable and issued in card or electronic form. Reloading to be done from bank account/ credit card/ full-KYC PPI. No reloading via cash	Shall be reloadable in nature and issued only in electronic form.	Not-reloadable	Reloadable
5.	Cash withdrawal / Funds transfer	Not allowed		Allowed For bankissued PPIs: Subject to limit of INR 2000 (approx. USD 26) per transaction; Overall monthly limit of INR 10,000 (approx. USD 133) across all locations. For non-bank issued PPIs: Maximum of INR 2000 (approx. USD 26) per transaction within an overall monthly limit of INR 10,000 (approx. USD 133).	Not allowed	Not allowed

29. As per the Master Direction on KYC: https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11566
30. Id.

6.	Limits of funds transfer	N/A		In case of preregistered beneficiaries, funds transfer limit shall not exceed INR 200,000 (approx. USD 2662) per month per beneficiary. For all other cases – limit is INR 10,000 per month (approx. USD 133).	N/A	
7.	Monthly/yearly loading limits	Monthly – INR 10,000 (approx. USD 133). Yearly – INR 1,20,000 (approx. USD 1600).		No separate limit – PPI issuer may decide	Maximum value shall not exceed INR 10,000	No specified limit – PPI issuer may decide
8.	Outstanding amount limit	Shall not exceed INR 10,000 (approx. USD 133).		Shall not exceed INR 2,00,000 (approx. USD 2662)	N/A	Shall not exceed INR 3,000 (approx. USD 40)
9.	Closure of PPI	Allowed to close the PPI at any time; Closure proceeds can be transferred 'back to source account'		PPI issuer to give an option to close the PPI and transfer the balance as per the applicable limits	PPI may be revalidated (including through issuance of new instrument) when requested by PPI holder.	PPI may be revalidated (including through issuance of new instrument) when requested by PPI holder.
10.	Interoperability	Mandatory – see below for detail			Not mandatory - have the option to offer interoperability	Exempt from providing interoperability
11.	Additional Factor Authentication Required	All wallet transactions involving debit to the wallet, including cash withdrawal, shall be permitted only by validation through a Additional Factor Authentication (such as One-Time - Passwords or PINs). Through recent RBI circulars,[31] recurring payments up to an amount of INR 5,000 per transaction may be exempt from the AFA requirement subject to customer consent and preferences.			Not mandatory	Not mandatory
12.	Validity/ Redemption	PPIs issued in the country shall have a minimum validity period of one year from the date of last loading / reloading and can have a longer validity period as well. Non-bank PPI issuers cannot transfer the outstanding balance to their Profit & Loss account for at least three years from the expiry date of PPI. Refunds must be made in the event the PPI holder requests a refund after this three year period.				
13.	Maintenance of Logs	PPI issuers are to maintain a log of all the transactions undertaken using the PPIs for at least ten years, which must be made available for scrutiny to RBI or any other agency / agencies as may be advised by RBI.				

iii. Eligibility for Authorization

Both banks and non-bank entities may apply for authorisation from the RBI to issue Small or Full KYC PPIs. Key points on the eligibility criteria to seek authorisation are as follows:

a. Type of entity: Non-bank entities applying for authorisation must be company incorporated in India and registered under the Companies Act, 1956 / 2013.[32] It would therefore not be possible for entities that are LLPs or sole proprietorships to apply.

31. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11668; https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12002; https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12051&Mode=0. (last accessed November 30, 2021).

32. Entities having Foreign Direct Investment (FDI) / Foreign Portfolio Investment (FPI) / Foreign Institutional Investment (FII) are required to meet the capital requirements as under the Consolidated FDI policy guidelines of Government of India.

b. Charter Documents: The Memorandum of Association (MoA) of the non-bank entity must cover the proposed activity of issuance of PPI.

c. Net worth: PPI issuers are required to have a minimum positive net worth[33] of INR 50,000,000 (approx. USD 680,000) at the time of submitting the application, with a requirement that PPI issuers must achieve a minimum positive net worth of INR 150,000,000 (approx. USD 2,040,000) by the end of the third financial year from the date of receiving final PPI authorization. This net worth is to be maintained at all times, and PPI issuers are required to submit their Net Worth Certificate (issued by a Chartered Accountant) every year.

iv. Application and Authorization Process

a. Application Process: Applicants must apply for authorization by submitting Form A[34] to the RBI. Once Form A has been submitted and if the RBI finds that the applicant has met the eligibility criteria, they shall issue an "in principal" approval, which is valid for 6 months, which may be extended for a year at the discretion of the RBI. The applicant would then be required to submit a satisfactory System Audit Report (SAR) and a net worth certificate of INR 5 crore within these six months. Once this is submitted, RBI may then grant a final certificate of authorization, which maybe for a perpetual period, subject to meeting certain conditions,[35] as was clarified in a circular issued in December 2020[36].

b. Introduction of a Cooling Period to Ensure 'Serious Applicants': As was clarified in a circular issued in December 2020,[37] the there is a cooling period of one year before the following entities may re-apply for PPI authorization:

- PPI issuer whose Certificate of Authorization (**"CoA"**) is revoked or not-renewed for any reason; or
- CoA is voluntarily surrendered for any reason; or
- Application for authorization has been rejected by RBI; or
- New entities that are set-up by promoters involved in any of the above categories.

c. Financial regulator NOC: Both banks and non-banks regulated by any "financial sector regulator" and seeking authorization under the Master Direction must submit a No Objection Certificate (NOC) from their respective regulator as part of the application for authorization.

d. 'Fit and proper' status: The RBI has extended the fit and proper criteria (which typically applies to banks and NBFCs) to entities applying for authorization under the Master Direction. Further, directors of the applicant are required to submit an undertaking.

e. Changes in Products/Features/Change of Control: The PPI Regulations mandate that any proposed major change, such as changes in product features / process, structure or operation of the payment system,

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33. 2.7 Net-worth : Shall consist of 'paid up equity capital, preference shares which are compulsorily convertible into equity capital, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of assets but not reserves created by revaluation of assets' adjusted for 'accumulated loss balance, book value of intangible assets and deferred revenue expenditure, if any'. While compulsorily convertible preference shares reckoned for computation of net-worth can be either non-cumulative or cumulative, these shall be compulsorily convertible into equity shares and the shareholder agreements shall specifically prohibit any withdrawal of this preference share capital at any time.
34. https://rbidocs.rbi.org.in/rdocs/Forms/PDFs/PSSACRT130215.PDF (last accessed November 30, 2021).
35. Full compliance with the terms and conditions subject to which authorisation was granted; Fulfilment of entry norms such as capital, net worth requirements, etc.; No major regulatory or supervisory concerns related to operations of the PSO, as observed during onsite and / or offsite monitoring; Efficacy of customer grievance redressal mechanism; and no adverse reports from other departments of RBI / regulators / statutory bodies, etc.
36. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12000&Mode=0 (last accessed November 30, 2021).
37. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12001&Mode=0 (last accessed November 30, 2021).

etc., as well as any takeover or acquisition of control or change in management of a non-bank entity is to be communicated to the RBI within 15 days of such change taking place. In the past, there have been conflicts as the 2017 Regulations had a reporting requirement, while the terms and conditions of the PPI Authorisation had provided for an authorisation to be sought for the above changes. Hence, going forward, this point should be clarified in the PPI authorisation terms and conditions for consistency.

v. Co-branding

In the event an entity does not wish to seek RBI authorization itself, the PPI Regulations allow entities to co-brand with existing PPI Issuers in order to issue PPIs. In such instances, companies incorporated in India (which may also be a Government department / ministry) are allowed to co-brand with existing PPI Issuers. The PPI Regulations prescribe certain conditions for co-branding on the PPI Issuer, which include having a board approved policy that allows for such co-branding, and conducting due diligence and KYC, to name a few.

Additionally, the PPI Issuer is to be liable for all acts of the co-branding partner, and will be responsible for all customer related aspects of the PPI. Whilst a one-time approval is still required for PPI Issuers to issue co-branded PPIs, the erstwhile requirement under the 2017 Regulations to report specific co-branding arrangements to the RBI has been done away with.

vi. Customer Protection / Grievance Redressal

A few key conditions under the PPI Regulations are that:

a. PPI Issuers are required to disclose all important terms and conditions in clear and simple language (preferably in English, Hindi and the local language) to the holders while issuing the instruments. The Frequently Asked Questions (FAQs) pertaining to PPIs are to be displayed on the PPI Issuer's website/application.

b. A formal, publicly disclosed customer grievance redressal framework is to be put in place.

c. PPI issuers are to clearly indicate the customer care contact details, including details of nodal officials for grievance redressal (telephone numbers, email address, postal address, etc.). Further, a detailed list of the PPI Issuer's authorised / designated agents is also to be displayed.

d. PPI Issuers are expected to initiate action to resolve customer complaints preferably within 48 hours and endeavour to resolve such complaints no later than 30 days from the receipt of the complaint.

vii. Interoperability

The 2017 Regulations had mandated that interoperability (the ability to use one payment system with another) would be implemented in phases, and that operational guidelines on interoperability would be issued. An RBI Circular issued in May 2021[38] subsequently mandated that KYC compliant PPIs were to ensure interoperability, while PPIs for mass transit systems and gift cards are exempted. This involves interoperability of PPIs issued via wallets and card networks, PPIs issued via card networks, and PPIs issued via UPI. Technical and operational requirements have been issued in this regard.

38. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12094&Mode=0 (last accessed November 30, 2021).

viii. Co-mingling of funds

Settlement of funds with merchants shall not be co-mingled with other businesses, if any, handled by the PPI issuer, or with any other activity that they may be undertaking such as Business Correspondents of bank/s, intermediary for payment aggregation, payment gateway, etc.

ix. Cross border transactions

Use of INR dominated PPIs for cross border transactions is not permitted, except in the below instances:

a. Cross border outward transactions[39] via Full KYC PPIs issued by authorized dealer banks, subject to foreign exchange laws. This feature may be enabled only on explicit request of the PPI holder and will be subject to transaction limits, i.e. not exceeding INR 10,000 per transaction, and INR 50,000 per month. Such PPIs shall not be used for cross border outward fund transfers or payments under the Liberalized Remittances Scheme (LRS).[40] Further, such PPIs cannot be issued by non-banks.

b. Cross border inward transactions via Full KYC PPIs issued by both banks and non-banks appointed as Indian agent of authorized overseas principals to beneficiaries of inward remittances under the Money Transfer Services Scheme (MTSS) of RBI. This is subject to certain conditions as prescribed under the PPI Regulations.

x. Settlement/Escrow Account

Non-bank PPI issuers are to process settlements only through sponsor banks, and are required to maintain outstanding balances in an escrow account with scheduled commercial banks.

xi. Outsourcing Considerations

The RBI has also released regulations for the outsourcing of payment and settlement-related activities to third party service providers non-bank payment system operators / providers, which include PPI Issuers. Hence, entities not directly regulated by the RBI may be subject to certain contractual compliances and restrictions imposed by payment system operators as part of the latter discharging their legal obligations. You may read more about this development here[41].

xii. Customer Protection Guidelines

PPI Issuers must also follow certain RBI Guidelines on limiting liability of customers in unauthorized electronic banking transactions. These guidelines prescribe obligations such as reporting of unauthorized payment transactions to customer, and limiting customer liability in certain instances.

C. Conclusion – Need for Further Liberalization

The compilation of the various circulars released by the RBI on PPIs through the years, as well as the clarity on Closed System PPIs, opening up the offering of PPIs permitting cash-based withdrawal to non-bank PPI Issuers, and the detail on Interoperability are a welcome change to the industry. The mandate on all debits to PPI

39. For permissible current account transactions under FEMA, i.e. for purchase of goods of services.

40. Further, prefunding of online merchant's account shall not be permitted using such Rupee denominated PPIs.

41. https://www.nishithdesai.com/NewsDetails/4796 (last accessed November 30, 2021).

instruments requiring AFA, however, may see a mixed reaction as this would take away from the convenience that PPIs offer customers.

A few suggestions to further liberalize the regime are as follows:

Taking a leaf out of UPI's book, RBI could consider opening up cross border transactions to boost market entry and ease of doing business for foreign players.

The high net worth requirements continue to be a barrier to market entry, which would explain why there are barely any new players who enter the space. Entities who do not wish to come up with these high net worth requirements often turn to co-branding or white labeling arrangements.

When it comes to co-branding requirements, the PPI Regulations still do not allow foreign entities to co-brand with PPI Issuers, which is an unnecessary hurdle for offshore players.
The mandatory requirement to 'convert' cash-loading Small PPIs to Full KYC PPIs within 24 months from the date of issue, may lead to pressure on issuers to alter their business models to provide PPI holders with added features. It should be clarified whether the requirement is for cash-loading Small PPIs to merely complete the KYC within 24 months, or whether to convert the instrument to the nature of a 'Full KYC' PPI as envisaged under the PPI Regulations, which can also be used for funds transfer and cash withdrawal.

Overall, while it is acknowledged that there has been limited liberalization of the PPI regime via exempting recurring payments, and extending the authorization for a perpetual period, further steps towards liberalization would be appreciated by the industry to revive the growth of PPIs in India, especially when compared to the tremendous growth and volumes of UPI, mobile banking and 'buy-now-pay-later' payments.

– Inika Charles, Aaron Kamath & Huzefa Tavawalla

November 24, 2021

VI. View: Two tremendous transitions too soon for Digital Payments Industry

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THE ECONOMIC TIMES | Industry

A. Industry players need a breather post recurring payments revamp

The Reserve Bank of India (RBI) has with effect from October this year completely revamped the regime for online automatic payments, leaving online merchants gasping. Payment aggregators and online merchants now need to brace for another potentially disruptive transition from January 1, 2022. Effective from the new year, payment aggregators and online merchants cannot store card and certain payment data, as a result of RBI's concerns around alleged data leaks in the fintech space involving volumes of card information. RBI provided tokenization of card data as an alternate solution. A balanced approach is needed to consider the interests of all stakeholders viz. consumers, e-commerce merchants and fintech players. Given that extensive technological, operational and integrational aspects need to be developed, tested and deployed in the payments ecosystem, RBI should consider a transitional timeline of at least 6-12 months for solutions such as tokenization to be implemented.

B.Healing from the automatic payments wound

Many of you would have received multiple communications from your banks in September informing you that your online subscription automatic payments may be discontinued from October 1, 2021 and would need to be re-registered. This was because back in September 2019, the RBI introduced an entirely new regime to register online automatic payments. The new regime required banks not to permit recurring payments unless the e-mandates are registered in under the new regime.

On the face of it, two years seemed a liberal timeline for implementation of the new regime, though the reality is that reportedly, over 70% of standing instructions failed on October 1, 2021 and many continue to fail.[42] This is primarily because banks did not implement requisite infrastructure on a timely basis, as they were not legally mandated to by the RBI. Those affected were consumers whose subscriptions payments were not only interrupted but many of which were not able to re-register under the new regime. This led to users having to manually effect payments reducing payment success rates leading to loss of revenues for merchants.

C.New conundrum to tackle on new years' day

Under a separate set of directives regulating payment aggregators, the RBI has prescribed that effective from January 1, 2022 neither payment aggregators nor online merchants can store customer card and related data. The RBI in March this year further clarified that merchants cannot 'payment data' without defining or clarifying the meaning of such a term and the items of data included with its scope.

42. https://www.livemint.com/industry/banking/why-payment-policies-have-triggered-chaos-11635786988391.html, accessed on Nov 15, 2021.

D. Tokenization the talk of the town

Storage restrictions will require users to fill in their card or other payment instrument details for every online transaction. Manual filling of payment instrument details would be required for each online transaction affecting payment latency rates, user experience, continuity of customer service and revenues of online merchants. Furthermore, auto-recurring payments would not be possible. This would disrupt online services that consumers have subscribed to leading to inconvenience, whether the services are for consumers' personal enjoyment or earning personal livelihood, examples include domain registrations, web-hosting services etc.

To remedy this inconvenience, card-on-file (CoF) tokenization can be considered, which entails a token which is device-independent and consists of the card, token requestor and merchant details. The process essentially involves the storage of 'tokens' that do not consist of, contain or identify any of the users' payment or card data, but corresponds to the payment instrument of a user. However, the tokenization process comes with its own set of challenges.

E. Patience is key to efficiency

Tokenization is a process which involves multiple stakeholders including the merchant, token requestor, payment aggregator, token service provider, card network and banks and in some cases technology infrastructure or services providers. While the RBI imposed restrictions on data storage in March 2020, the CoF tokenization was permitted by the RBI only in September 2021. Stakeholders essentially have only 3 months to design, implement and test viable infrastructure, which isn't remotely enough. One weak link will cripple the entire infrastructure.

It is understood from industry players that even if banks are ready with their technology integrations, merchants would need at *least 6 months* to integrate their systems for CoF tokenization. This additional time is important for merchants to conduct necessary testing on the new infrastructure for robust system functionality, security and performance.

F. Operational hurdles

Additionally, certain operational challenges need to be ironed out.

- One issue pertains to the requirement of purging existing data, which may lead to issues in the merchant initiating refunds, redressing complaints and offering rewards or incentives to users that have not been able to register their payment instrument details via tokenization. RBI should prescribe a transitional timeline for purging of card data for merchants' business continuity purposes and to prevent service disruption to consumers.

- Secondly, tokenization of a user's payment instrument requires their consent and additional validation, and the same process is required for a replaced or renewed instrument. This appears onerous since a user who receives a new card replacing their expired or lost card, would need to re-register the new card even though the new card has the same cardholder details and is linked to the same bank account and customer ID. RBI should consider a relaxation in re-tokenizing renewed/replaced cards linked to the same user account.

- Thirdly, RBI clarified that the last four digits of the card and cardholders name can continue to be stored for transaction tracking and reconciliation purposes. However, the first four or six digits that identify the bank (BIN) are also required to be stored in order to identify the issuer. The RBI should permit BINs to be stored, at least for security, tracking and reconciliation purposes.
- Fourthly, banks that have needed frequent nudges from the RBI and industry players in the past, should be mandated to implement the requisite infrastructure for enable tokenization.

The industry awaits much-needed clarifications from the RBI which could be issued in the FAQs, as done in the past.

- **Gowree Gokhale, Huzefa Tavawalla and Aaron Kamath**

2. Blockchain, Cryptocurrency and NFTs

September 23, 2021

I. Blockchaining Education- Legal nuances to know

The last few years have seen an unprecedented increase in the use of technology across sectors. The education industry in particular has adapted well to this change. It has integrated technology almost seamlessly into its existing frameworks, both for the delivery of course content and ancillary objectives like administrative tasks and solutions for paying fees. One such new, upcoming and revolutionary technology is blockchain, which offers potentially great solutions to the education sector, for storing certificates, verification of credentials, rewarding students for task completion and intellectual property management, *et al.*

A. What Is Blockchain?

Fundamentally, a blockchain is a decentralised network facilitating transactions between multiple participants usually across different locations. It stores a record of all transactions which occur on it in separate "blocks". It is 'decentralised' because these records are distributed across devices of each participant in the network, and no single entity controls the network, unlike traditional databases. In the case of public blockchains, this data can be accessed by anyone with an internet connection, while private blockchains generally require participants to provide a security key before they can access the blockchain database.

Blockchain offers a unique way for securing data through a decentralized system, and this storage is immutable in nature, meaning that data once stored on the blockchain cannot be removed, tampered with or altered by third parties. For instance, if a document is stored on a blockchain network in block "A", a change made to this document would create an entirely different block "B", making it possible to identify and track all changes made to the document in a secure manner.

Although blockchain came into vogue primarily as part of cryptocurrencies like Bitcoin, the distributed manner of storing information used by blockchain systems has several other uses which go much beyond payments and trading.

B. How Can it Be Used in The Education Sector?

The need to expand use blockchain technology in the education sector has been acknowledged by the government in the National Education Policy, 2020 (**"NEP"**). The NEP lists blockchain as one of the emerging technologies which will likely gain prominence in the education sector in the near future.[43]

i. Student Identity Verification

The permanent and highly secure nature of data stored on the blockchain can be leveraged by schools, colleges and universities to assign an identity to their students. A digital identity which is created for a student on the blockchain could have numerous benefits as well. It would enable schools and universities to easily create a record of a student, and to update their records in a secure manner. This digital identity can also be used by students as an all-access pass to use all virtual resources being offered by an institution. The key advantage of integrating the blockchain to verify student identities is that: (a) it is highly secure compared to digital solutions currently in the market; and (b) advancements of students can be easily tracked on the blockchain by studying the newer blocks added on the chain.[44]

43. National Education Policy, 2020 at page 56, https://www.education.gov.in/sites/upload_files/mhrd/files/NEP_Final_English_0.pdf (last accessed on September 21, 2021)

44. Andrew Tobin, Jamie Smith, Self-Sovereign Identity for Higher Education, https://www.evernym.com/blog/self-sovereign-identityhigher-education/ (last accessed on September 21, 2021)

ii. Authentication of university degree and certificates

As an example, the Massachusetts Institute of Technology (MIT) has been using blockchain technology to issue certificates to its students since 2015.[45]

In India as well, the use of blockchain in issuing authenticated and secure university certificates is being explored by an initiative called the SuperCert, a collaboration between the NITI Aayog and the Indian School of Business.[46] This platform has been proposed to issue course certificates through a permissioned blockchain architecture. Through SuperCert, each student is assigned a unique identity, which may be used by employers to verify the authenticity of their certificates. This system creates a fingerprint, or a hashed version of the certificates that are uploaded on the blockchain. At the time of verification, the SuperCert system compares this hashed fingerprint of the original certificates with the certificates provided to employers by students. Employers are informed in case any discrepancy is detected in the document provided by students. Such a system ensures that the privacy of students is protected (since employers do not access the original certificates which remain with the university), without compromising the authenticity of certificates.

In a recent development, the Maharashtra Government has announced that it intends to use an Ethereum-based blockchain network to verify student diplomas issued by the Maharashtra State Board of Skill Development (**"MSBSD"**).[47] This marks a first in the country, and it is expected that almost one million certificates will be issued in connection with this project. However, unlike the proposed SuperCert solution which relies on a private blockchain, the MSBSD's use of the Ethereum network to implement verification solutions will be on a public, permission-less blockchain, and interestingly, requires the use of 'Ether' a cryptocurrency / crypto-asset, to function.

Such usage of blockchain to verify certificates streamlines the process of issuing certificates by reducing the procedural formalities around it. It also significantly decreases the expenses incurred by educational institutions in issuing certificates and degrees, while ensuring the security of the document at the same time.[48]

iii. Tokens as Rewards for Task Completion

Another application that blockchain technology has in the education sector is through initiatives like "BitDegree"[49]. BitDegree is an example of a Massive Open Online Course (**"MOOC"**), and employs a "learn to earn" model. It uses the public Ethereum blockchain to build tokens which are used to incentivise its users who learn certain skills. Such tokens have limited uses, such as taking paid courses at educational institutes.

iv. Intellectual Property Management

Management of intellectual property in the context of academic research is a key application of blockchain. One such example is "Ledger", a peer-reviewed scholarly journal published online by the University Library System, University of Pittsburgh[50]. It allows users to digitally sign their documents using their bitcoin private keys, and timestamp published manuscripts in the blockchain. Such systems are helpful in automatically tracking the originators of documents and identifying authors. Since data stored on the blockchain is permanent and tamperproof, it is ensured that the integrity of academic research is preserved in a secure manner.

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45. Elizabeth Durant, Alison Trachy, Digital Diploma debuts at MIT, https://news.mit.edu/2017/mit-debuts-secure-digital-diploma-usingbit-coin-blockchain-technology-1017 (last accessed on September 21, 2021)
46. NITI Aayog Draft Discussion Paper, Blockchain: The India Strategy, January 2020
47. Ledger Insights, Indian state government launches blockchain educational certificates, ledgerinsights.com/indian-state governmentlaunches-blockchain-educational-certificates/(last accessed on September 21, 2021)
48. Rachel Wolfson, US Education Department Promotes Putting Student Records On Blockchain https://cointelegraph.com/news/useducation-department-promotes-putting-student-records-on-blockchain (last accessed on September 21 , 2021).
49. https://www.bitdegree.org/ (last accessed on September 21, 2021)
50. https://ledgerjournal.org/ojs/ledger/about (last accessed on September 21, 2021)

v. Payments

Blockchain technology may also be used by educational institutions to accept cryptocurrency payments from students as a safe and secure alternative to the traditional methods of payment, depending on the regulatory landscape for such methods in the relevant jurisdiction. Several universities across the world have begun to accept cryptocurrencies as a valid mode for the payment of tuition fees.[51]

C. Legal and Regulatory Challenges

i. Privacy and Data Protection

Widescale adoption of blockchain technology will certainly revolutionise the existing framework of the education sector. However, considering that this will involve the storage of highly sensitive personal data of students on a decentralised network, educational institutions should ensure that they take all possible measures to protect the information of their students on the blockchain.

The current regulatory landscape on data protection in India is governed by the Information Technology (Reasonable security practices and procedures and sensitive personal data or information) Rules, 2011 (**"SPDI Rules"**). The SPDI Rules define sensitive personal data to include information such as financial information, medical records, biometric information, etc. Under the SPDI Rules, body corporates which collect, receive, possess, store, deal or handle sensitive personal data of others, in an electronic form, must follow the requirements under these rules, which inter alia include obtaining consent for collecting such data from the providers of information and refraining from retaining the sensitive personal data for longer than required for the purpose of such collection.

The SPDI Rules will likely be applicable where data about student identities and degree certificates is made available on the blockchain. This is because such data is could include , biometric information and financial data, which is treated by the SPDI Rules as "sensitive personal data."

To comply with these requirements, any educational institution seeking to use blockchain networks for document verification will have to inform students (a) that this data is being collected to facilitate future verification, and (b) that data once stored on the blockchain cannot be removed.

The SPDI Rules also mandate that certain reasonable security practices are to be established when sensitive personal data is collected. The SPDI Rules further provide certain examples of standards which would be considered sufficiently reasonable.[52] Where universities are relying heavily on the blockchain to store student data, there is no clarity if such standards under the SPDI Rules can be considered to be satisfied. This is because these requirements under the SPDI Rules have been targeted at systems which store personal data in a single location. However, data on blockchains are stored in a decentralised and distributed manner, meaning that it may be practically impossible to implement these specific security standards in the systems of all participants on the blockchain network.

ii. Spill-over effects of a potential cryptocurrency ban

Recently, it was reported that, pursuant to an Inter-Ministerial Committee recommendation of 2019, the Indian government is considering a ban on dealing with all private cryptocurrencies.[53] However, in this context, the

51. Universities Accept Bitcoin Payments to Ease the Burden on International Students, https://www.analyticsinsight.net/top-universitiesand-schools-accepting-bitcoin-payments/ (last accessed on September 22, 2021)

52. IS/ISO/IEC 27001 standards on Information Technology - Security Techniques - Information Security Management System – Requirements

53. The Indian Express, RBI plans and an upcoming Bill: Where are digital currencies headed? https://indianexpress.com/article/explained/cryptocurrency-bit-coin-rbi-7285249/ (last accessed on September 21, 2021)

latest statement of the Finance Minister has been that "a futuristic thing can't be shut out".[54] The matter is reportedly pending consideration of the Union Cabinet.[55] A ban on cryptocurrencies may affect digital assets, including those generated by MOOCs such as BitDegree to reward students completing tasks successfully, as well as a pioneering program like that of the MSBSD, as discussed above.

Experts have opined that it may be difficult to separate blockchains from cryptocurrency.[56] This is because blockchains usually reward participants on the chain for expending energy to authenticate transactions by giving them crypto assets. Without such crypto assets, participants on the chain may not be incentivised to validate entries in the distributed blockchain ledger. Hence, a potential ban on cryptocurrencies may severely limit the use of blockchain technology for many of the purposes outlined above.[57]

One such example of a system which may be negatively impacted by a ban on cryptocurrency is that of the recent solution for certificate verification introduced by the Maharashtra State Government discussed above. Since this solution uses Ethereum, a public blockchain which relies on cryptocurrency to function, a crypto ban is likely to impede this initiative and restrict access to the certificates uploaded on the blockchain.

iii. Cybersecurity

Though the data storage and verification on the blockchain has been touted to be one of the most secure means ever devised, cybersecurity vulnerabilities are not entirely eliminated. For instance, there have been several recent situations where hackers gained unauthorised access to information on the chain, and exploited the information contained therein.[58] Though this is technically more difficult to achieve than by hacking traditional centralized systems, blockchain networks do have some vulnerabilities which may be exploited. For example, where blockchain networks rely on a majority consensus mechanism (meaning that a transaction on the blockchain is authenticated if more than 50% of the computing power of the network has authorised it), it would be possible for hackers to take over this system by gaining control of more than half of all the computing power on the network. This could have disastrous results where universities and other educational institutions rely on the blockchain to store and authenticate student information especially where the personal data of students is concerned.

To manage the risks presented by such eventualities, universities should implement strong cybersecurity frameworks including negotiating contractual protections with other participants and undertaking continuous monitoring of the network for security incidents.[59] In addition, such institutions should also ensure that they comply with requirements under the Information Technology Act, 2000 of India and similar laws which require body corporates to report unauthorised uses of computer resources to the relevant authorities within a reasonable timeframe.[60]

54. Hindustan Times, On Cryptocurrency, Sitharaman Says 'We Have To Be Cautious But Think It Through', https://www.hindustantimes.com/business/on-cryptocurrency-sitharaman-says-we-have-to-be-cautious-but-think-it-through-101632189095218.html (last accessed on September 22 , 2021)
55. Economic Times, Waiting for Cabinet approval, says FM Nirmala Sitharaman on bill on cryptocurrency, https://economictimes.indiatimes.com/news/economy/policy/waiting-for-cabinet-approval-says-nirmala-sitharaman-on-bill-oncryptocurrency/articleshow/85372886.cms?from=mdr
56. Russia's Crypto Ban Would Stifle Blockchains, https://news.bitcoin.com/buterin-ban-russia-stifle-blockchains/ (last accessed on September 21, 2021)
57. Note: Initiatives like SuperCert may not face this issue, since they rely on a private/permissioned blockchain, meaning that all participants on this chain can be identified by the central authority. The spillover effect may hence be a significant issue only where universities are taking resort to public blockchain structures. See https://www.steptoe.com/images/content/1/8/v2/189187/Cybersecurity-Tech-Basics-Blockchain-Technology-Cyber-Risks-and.pdf(last accessed on September 21, 2021)
58. MIT Technology Review, Once Hailed As Unhackable, Blockchains Are Now Getting Hacked, https://www.technologyreview.com/2019/02/19/239592/once-hailed-as-unhackable-blockchains-are-now-getting-hacked/ (last accessed on September 21, 2021)
59. https://www.steptoe.com/images/content/1/8/v2/189187/Cybersecurity-Tech-Basics-Blockchain-Technology-Cyber-Risks-and.pdf (last accessed on September 21, 2021)
60. See Reporting cybersecurity breaches in India – Is it time to overhaul the law?,by Aparna Gaur, Aarushi Jain, Gowree Gokhale and Dr. Mihir A. Parikh, available at https://www.natlawreview.com/article/reporting-cybersecurity-breaches-india-it-time-to-overhaul-law (last accessed on September 21, 2021).

iv. Our Take

The blockchain technology offers significant advantages to the education sector across the globe and could significantly decentralise and democratise access to education. In India, particularly, the opportunities offered by blockchain technology in the sector are only beginning to be explored by the government and private players alike. This also offers opportunities for new and allied business models in the education space.

Further, the government has presented a positive outlook towards the use of blockchain technology for improving education in the country under the NEP. We foresee more acceptability and adoption of blockchain in education in the new future.

– **Athira Sankar, Jaideep Reddy & Aarushi Jain**

April 27, 2021

II. Crypto for Covid relief, our thoughts on NFTs, future regulation, and more

Crypto For Covid Relief, Our Thoughts On Nfts, Future Regulation, And More

Over the weekend, in less than 24 hours, a fundraising initiative by well-known Indian crypto-asset entrepreneurs was able to gather crypto-assets worth over USD 1 million / INR 7.5 crore, and counting. The initiative was started with a heartfelt message on Twitter and the publication of an Ethereum smart contract address (available here). With just that, contributions have poured in from all over the world, including from Vitalik Buterin, Co-Founder, Ethereum, who contributed over USD 600,000 / INR 4.5crore. In fact, persons have made contributions starting from 0.005 Ether (approx. INR 175).

Of course, the regulatory compliance of the initiative should be assessed closely and structured accordingly. Contributions should be made and brought into India in a manner compliant with the Foreign Contribution (Regulation) Act, 2010, which regulates all donations made by foreign sources, and the Foreign Exchange Management Act, 1999, which regulates inflow and outflow of foreign exchange.

What the initiative shows, however, is the power of crypto-assets for fast, permissionless, cross-border payments, including micro-payments, for a noble cause. The traditional banking system is unlikely to have been able to process as many transactions, particularly micro-transactions, across as many borders in as short a time period. Compounding the surge of mainstream credibility - particularly over the past year - in the crypto-asset and blockchain space, this initiative shows the power of the 'Internet of Value' to bring benefits to a nation.

Over the past few months, we have written extensively on the space, including:

An article by Jaideep Reddy and Vaibhav Parikh on key developments in the crypto-asset and blockchain space and the future of its law and policy in India, published in The Hindu Business Line on April 20, 2021.

An article on Jaideep Reddy, Meyyappan N. and Vaibhav Parikh on Non-Fungible Tokens (NFTs), explaining the concept in simple terms and its Indian law implications, published in The Economic Times Tech on April 8, 2021.

A television interview by Jaideep Reddy on CNBC-TV18 in March 2021 discussing the way forward for India in crypto-asset and blockchain law and policy.

Our letter in September 2020 to the Government of India discussing why a prohibition on crypto-assets is not the appropriate way forward as a matter of law or policy, and proposing a regulatory framework instead, including a licensing and KYC regime for intermediaries.

A detailed law review article by Jaideep Reddy published in the Indian Journal of Law and Technology, National Law School of India University, Bengaluru, discussing why an outright ban on crypto-assets is likely to be unconstitutional and why a regulatory regime should be considered instead.

2.Blockchain, Cryptocurrency and NFTs

After the landmark Supreme Court judgment in Internet and Mobile Association of India v. Reserve Bank of India in March 2020, where we represented the petitioners, the ecosystem has flourished in India with a wealth of innovative activity. Further legal clarity was obtained when the Karnataka High Court in February 2021 quashed criminal proceedings against the founders of Unocoin Technologies Private Limited, who we represented, for starting a crypto-asset kiosk machine in Bengaluru, India.

- **Crypto-Asset and Blockchain Team**

November 30, 2021

III. Don't ban cryptocurrencies, instead set up a regulatory body

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Whether you are for or against bitcoins and cryptocurrencies, you cannot deny their importance as an evolution in money and banking. In a short span of 13 years, cryptocurrencies have gained mass acceptance and popularity, paving the path for a more inclusive economy. According to the CNBC Millionaire Survey 2021, nearly half of the millennial millionaires have at least 25 percent of their wealth in cryptocurrencies.

There are approximately 150-200 million crypto users worldwide and about 15-20 million in India, according to Nischal Shetty, CEO of WazirX. Not all are drug peddlers or terrorists. Many of them are highly sophisticated and reputed investors. This means a large number of people have seen the benefits of investing in crypto.

Before considering a ban, it must be inquired as to why people are valuing cryptocurrencies so highly and what benefits they perceive. It should not happen that years later, we find that India has missed being part of a major financial revolution. The government's decision has to be evidence-based. Legislators must study the approaches taken by various countries prior to coming out with a regulation.

There is absolutely no denying that crypto has been used for illegal purposes, but so has cash or 'fiat'. All technologies are a double-edged sword. The same knife that is used to cut vegetables can be a murder weapon. To pass the entire burden of terror financing onto crypto is simply unfair. In 2012, HSBC admitted to moving large sums of dirty money for Mexican drug cartels and paid a hefty fine for doing so. At the time, none of our politicians debated about banning the banking system, so why do they give this step-sisterly treatment to crypto?

It is clearly evident that cryptocurrencies are going to disrupt the banking and monetary system, just like email disrupted the postal and telegraph service. Presently, the gatekeepers are trying to stop change instead of adapting to it. Rather than banning crypto, it is important for governments to nurture it and let it evolve.

India is strategically poised to capitalise on this technology. Our great country has one of the largest talent pools of innovators, especially in the IT sector. India is also home to some of the best programmers in the world and leveraging their skills could make us a powerhouse in blockchain technologies. A liberal framework would put India's economy into hyperdrive and speed up the goal of a $5 trillion economy.

Conversely, if cryptocurrencies are banned, India will witness a mass exodus of highly talented innovators, programmers and computer scientists. The first casualty would be the 'crypto miners' and software developers. Public blockchain cannot survive without an incentive mechanism, which cryptocurrencies provide. Foreign blockchain companies that have subsidiaries in India would have to move away from India. New Indian blockchain enterprises will have to be incorporated outside, hence Indian IP would be lost in addition to tax revenues. We will lose the ability to raise global capital by way of legitimate token issuance.

So, where is the value of crypto for India? Most immediately, it eliminates intermediary costs. Today's banking system is designed for the rich. If you are sending millions of dollars across borders the banks charge a much lower transaction fee, while the transfer costs for small amounts could be as high as 7-10 percent. This has a direct effect

on the foreign remittances market, which brings close to $75 billion from the Indian workers abroad. Crypto can save India a sum of $7.5-10 billion in transaction fees. This amount can possibly be used to fund the entire mid-day meal programme for the nation.

The potential of crypto is enormous and banning it would be throwing the baby out with the bathwater. We must prevent its nefarious uses through regulation. In its judgement of March 2020, the Supreme Court has already said that banning cryptocurrencies is extreme and unconstitutional, and regulating the space would be more appropriate. We can't ban technology, but we can certainly regulate the behaviour of the actors. Just imagine, what would have happened to India if the Internet and websites were banned?

Crypto is driving huge growth in the Indian technology ecosystem. Two of India's 31 unicorns are crypto companies. A recent report by NASSCOM found 32 potential benefits of the crypto technology for the citizens, industry and the Indian economy. The report states that the industry currently provides employment for 50,000 individuals in India and that there are $6.6 billion worth of investments in crypto assets by retail investors in India.

The report projects that by 2030, the industry can create eight lakh plus jobs in India and can potentially create an economic value addition of $184 billion in the form of investments and cost savings. This would also create corresponding tax revenue for the government.

Non-Fungible Tokens have helped small and medium creators access a worldwide market for their work. NFTs reside on public blockchains like Ethereum. To create and transfer NFTs, participants need to pay network fees in crypto. Without crypto, therefore, NFTs cannot be successful in India.

Cryptocurrencies have also proven to be socially beneficial. India Crypto Covid Relief Fund (which gathered donations in crypto-assets from all over the world) has donated over $36 million/Rs 270 crore. towards Covid relief in India, with another $429 million pending donation. UNICEF launched a 'Crypto Fund' allowing it to receive and disburse cryptocurrencies to fund projects in emerging markets. The World Food Programme is using cryptocurrency networks to expand refugees' choices in how they access and spend their cash assistance.

It is understood that the government is planning to come out with a Central Bank Issued Digital Currency (CBDC). Indeed, they should experiment with it but banning other decentralised cryptos would be inappropriate. Let there be fair competition. Both approaches are based on 'trust', there is no tangible asset to back them. People will decide and adopt the ones in which they have greater trust and faith.

Indeed, both should have an enabling and promotional regulator along with the lines of Insurance Regulation and Development Authority (IRDA). Is it the right time for a Cryptocurrency Regulation and Development Authority (CRDA)?

- **Suril Desai**

February 4, 2022

IV. NFTs through IPR lens

Non-fungible tokens a.k.a. NFTs have taken the media industry by storm. From Big B- Amitabh Bachchan to the one and only Bhai- Salman Khan to singers like Sonu Nigam to cricketer-cum-celebrities Yuvraj Singh, and production houses like Viacom, there are now enough and many examples of the media industry foraying into this space. There is no dearth of variety either. Drawings, cartoons, caricatures, and posters (artistic works), songs and tunes (musical works), scripts and dialogues (literary works) and films themselves (cinematographic work) are being sold as NFTs. Options are limitless. Our Indian film industry is fully aware of this. Henc,e the need to understand the issues related to rights in NFTs.

A. Creating NFTS from Existing Works

The (Indian) Copyright Act, 1957, like most copyright legislations around the world, defines copyright widely. All modes and mediums of exploitation of a work are considered as “rights” . Due to the wide definition, copyright is considered a bundle of rights and each right within the bundle is capable of separate ownership or license. Creating of NFTs in relation to copyrighted works is also one of the rights from this bundle.

Thus far, media contracts were not negotiated to specifically call out the right to create and sell NFTs. This is changing. Now stakeholders are starting to negotiate NFTs as a specific right. It would be interesting to see how existing contracts get interpreted i.e. who will be considered to have that right. E.g. if a producer has granted digital right to a streaming platform, would such streaming platform have a right to create NFT as well because NFT could be construed as falling within definition of digital rights. This will depend upon the manner in which the definitions and clauses are drafted.

It is therefore important to review chain of title documents carefully to determine what rights have been given to which party, to avoid legal actions. Quentin Tarantino’s legal dispute with Miramax over Pulp Fiction is an interesting precedence in this space.[61]

When a NFT is made of a video clip where a performer or sports personality is included, the agreement with such individuals should also be examined. E.g. usually, performers grant a right to use their attributes, caricature, voice, etc. in relation to the working which their performance will be used such as the film, web series, interview, etc. Hence, separate permission may not be required from the performer. However, if the performer has reserved some rights (example, gamification or merchandising rights) then the use of NFT has to be seen to evaluate if a permission is needed or not. The performer may also ask for share of consideration received from the sale of the NFT, including subsequent sales of that NFTs. If the NFT is used to endorse a product or brand that may lead to separate commercial negotiations.

If you are not the owner of the original work, but want to create a NFT based on a work that you have identified (say a poster of a film), then you need to approach the appropriate right holder for permission to create the NFT. Else, you could be infringing someone’s copyright and heading for a dispute.

61. See Miramax Sues Quentin Tarantino Over Pulp Fiction NFTs | Time

B. Buyers Rights

Buyer has limited rights in the NFT. Comparing this to a real world scenario, a buyer of a prized painting typically has the right to say he/she own it (bragging rights), display or exhibit it, and to even sell it onwards. The buyer does not get the right to make copies of the painting, or monetize it in other mediums-such as printing it on tshirts etc. The same logic applies to NFTs as well since it is nothing more than a digital copy of a work.

Newer models are developing quickly in this space and sometimes the buyer may also get the right to earn from the investment made in the NFTs. An example is of the Blockchain-based music investment platform Royal will let fans invest in hip-hop legend Nas music on the platform.[62] Investees in NFTs issued for the song will receive is a share from royalties every time the music is streamed. Thus, they are stakeholders in money earned from exploitation of the song, though not the owners of the IP in the song. This is similar to investing in mutual funds. The fund invests your money in various securities and pay earnings to you. It does not make you the owner of the security in which the money is invested.

C. Trademarks and NFTS

NFTs are a product offering. They can have a name – which could be a trademark. They can also incorporate a trademark -for instance a film, image, or song may include a brand name in it. If such use of trademark or brand is unauthorized, then it could result in exposure to a trademark infringement or passing off suit. There is already precedence in the west on unauthorized trademark usage in NFTs.[63] Brand building is a time and capital intensive exercise. Many organizations take protection of their brands very seriously. Hence, it is important to clear use of trademark before incorporating or using it for a NFT.

D. Legal Action

A claim will lie against the creator of the infringing NFT at the first instance, especially if the creator retains the intellectual property (**"IP"**) rights in the NFT. At times, ell the NFT platform may be impleaded as well (for facilitation such infringement) in a legal action. Since most NFT platforms are marketplaces which are only providing a platform for sale and purchase of NFTs, they are likely to qualify as intermediaries under the Information Technology Act, 2000. As such, they will be able to take safe harbour and defend a liability as long as they take down the infringing content upon receipt of actual knowledge by way of a government authority or court's order.

E.A Word of Advice

NFTs are a new medium of exploitation of work. Hence, a through diligence of chain of title documents is important to ascertain that the NFT seller has the rights to create, and sell the NFT. IP centric representation, and indemnities should also be built in the smart contracts meant for sale of NFTs from a buyer protection perspective. Blockchain will make the examination of chain of title easier for subsequent sales but won't rescue at the listing stage. Hence the need for diligence, else there could be several IP related claims which would in turn have a negative impact on NFTs overall.

– Aparna Gaur, Aarushi Jain & Gowree Gokhale

62. See https://www.lexology.com/library/detail.aspx?g=92d81306-ca86-47ca-b570-34ad16483039
63. https://indianexpress.com/article/explained/hermes-lawsuit-metabirkins-mason-rothschild-nft-7736973/

March 1, 2022

V. The RBI stand on Crypto lacks Balance

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A public authority has to be neutral and impartial. While some concern over cryptocurrencies is understandable, recently the Reserve Bank of India (RBI) compared crypto to a Ponzi scheme and the tulip bubble (or worse), and proposed an outright ban, a lack of balance.

Cryptocurrency is a platform technology. Like the Internet, they can be used for good and for bad. The Net facilitates child pornography and terrorism (and cryptocurrencies themselves), but no one seeks to ban it. Many of the criticisms of cryptocurrencies in the February 14 speech of the RBI deputy governor apply equally to the internet. Like crypto, the net can also be linked to an anti-establishment ideology. Remember John Perry Barlow's 1996 Declaration of the Freedom of Cyberspace, which asked governments to leave the trap alone? Cryptocurrencies are criticized for being global, decentralized and bypassing middlemen. But why should it be bad? Email is global, it obfuscates the post office, and it's useful. We are reminded of a 1995 Newsweek article that said this about the Net: "We've been promised instant catalog shopping – just point-and-click for great deals. ...so how about my local mall Does more business in an afternoon than the entire Internet handles in a month?"

One does not expect RBI to praise the cryptocurrency, but one expects it to take a balanced approach, so that it does not gloss over the pros and only highlight the cons.

The speech's argument that cryptocurrencies cannot satisfy any requirements in the financial sector can be dismissed. According to World Bank data, India was the largest receiver of inward migrant remittances worth $87 billion in 2021. But the average cost of sending remittances to India in 2020 was 5.4%. it over. translates into 30,000 crores in cost, almost three times our annual midday meal budget. Given the permissible regulations, this money can be saved, as many cryptocurrencies allow cross-border transfers within seconds at near-zero costs. Cryptos have proved useful in many other contexts as well, including the World Food Program and power schemes by UNICEF and helping to raise thousands of crores for COVID relief in India. In fact, despite speech claiming that a crypto ban will not harm blockchain technology, it fails to note that many 'blockchain' innovations are powered by native cryptocurrencies, such as the Maharashtra State Board of Justice based on Ethereum. Certificate verification program of skill development, and non-fungible token (NFT) offerings by Indian creators and media houses. While the largest global institutions and academics, including Turing Award winners, and some of the best Indian minds acknowledge the technological success of cryptocurrencies, the RBI remains in disbelief.

Some relevant facts were also missed in the speech. Citing a source that estimated the value of crimes using cryptocurrencies globally at $14 billion in 2021, it did not note that the same source found that illegal activity accounted for just 0.15% of total crypto transaction volume. . The speech also said that illegal transactions have been "largely filtered out of the formal financial system", but did not cite the RBI's own annual report, which found that the total amount of fraud in the Indian banking system in 2020-21 was over. 1.38 trillion (which is over $14 billion). Still, no one would call it a "ponzi scheme".

Even though RBI wants to express a strong dislike for cryptocurrency, a ban call disregards our constitutional plan. It is a basic constitutional principle that the state does not decide private matters for its citizens. In a famous

case on the right to privacy, the Supreme Court declared, “The best decisions on how life should be lived are left to the individual.” Citizens have the right to participate in a new technology wave and be a part of what is. Known as the Fourth Industrial Revolution. Millions of Indians are doing this. The RBI had already made a caustic claim in the Supreme Court defending its 2018 circular on virtual currencies, which the court found lacking empirical basis, disproportionate and therefore unconstitutional. A long line of cases has assumed there is a high bar for the state to ban something. Mere dislike is insufficient. The speech had no underlying economic data, including any projections, to show how cryptocurrency is actually “ruining” the economy. which has been mentioned that regulation cannot solve. The speech asked how the case of mis-selling would be redressed if the cryptocurrency was not banned. Some research suggests that cryptocurrency fraud cases have already been prosecuted in India. In fact, law enforcement agencies use a combination of publicly available blockchain logs and information gathered from exchanges and banks to trace criminals. The ban would deprive law enforcement agencies of this information.

The outright ban on cryptocurrencies is likely to be excessive and unconstitutional. Even in the winter session of Parliament, the finance minister said the previous draft proposing the ban was being reworked. The chairman of the committee which made this proposal also now advocates regulation instead of prohibition. Therefore, it is expected that the RBI will reconsider its extreme stance. Meanwhile, India may need to set up a crypto regulatory and development authority—say, a multi-stakeholder regulatory authority with expertise in computer science, regulation and economics—that can help us move the conversation forward.

These are personal views of the author.

- **Nishith M. Desai and Jaideep Reddy**

3. Tax

February 4, 2021

I. Equalisation Levy Expansion 2021 – How Does it Affect Marketplaces and Online platforms

The infamous amendment by the Finance Act, 2020 expanded the scope of Equalization Levy (**"EL"**) to apply EL on the amount of 'consideration received or receivable' by an e-commerce operator from e-commerce supply or services made or provided or facilitated by or through it to specified persons (**"Expanded EL"**).

The Memorandum to the Finance Bill, 2021 (**"Finance Bill"**) notes that the Government felt the need to provide certain clarifications to correctly reflect the intention of certain provisions of the Expanded EL. The changes have brought with them further questions and potentially unintended consequences.

However, there are further doubts now regarding whether the scope of the Expanded EL is large enough to cover situations where even a communications platform or a payment aggregator could be covered within its scope, even though no commission is earned by it. For example, if a non-resident platform enables users to message each other and two parties agree to sell a tangible good, would such platform be required to deduct EL at 2% even though it provides free services to the users, may not even be aware of the transaction happening and in any case is not responsible in any ways for collecting or settling payments between the users.

In this hotline, we discuss the impact of the definition of *'consideration received or receivable from e-commerce supply or services'* proposed under the Finance Bill and the potential impact on different digital business models. We also seek to highlight the numerous problems and practical challenges in going down this path. We take a plain vanilla example which was what the amendment sought to presumably address and then we analyse possible unintended consequences.

A. Amendment by Finance Bill

The term 'consideration received or receivable' was not defined under the provisions of Expanded EL as introduced by the Finance Act, 2020. In case of marketplace e-commerce operators, whereby the e-commerce operator is merely facilitating the sale of goods or provision of service between the seller and buyer on its platform in lieu of commission from the registered seller or buyer or both, it was unclear whether the Expanded EL would apply on the entire consideration of the transaction or only on the commission earned by the e-commerce operator. It appears that in this context the Finance Bill has proposed to define the term *'consideration received or receivable from ecommerce supply or services'*.

The Finance Bill proposes to define the scope of *'consideration received or receivable from e-commerce supply or services'* to include the below:

a. consideration for sale of goods irrespective of whether the e-commerce operator owns the goods;

b. consideration for provision of services irrespective of whether service is provided or facilitated by the e-commerce operator.

This has the potential to have a significant impact on marketplaces operated by the e-commerce operators since the Expanded EL is now likely to apply on the total value of the sale of goods or provision of services facilitated by them as opposed to being charged only on any commission earned by the platform. This is likely to create cash flow issues for the e-commerce operators. Further, it is unclear whether Expanded EL will be applicable in

situations wherein marketplaces facilitate sale of goods or provision of service without charging any commission from either the buyer or seller.

B. Unintended Co NSEQ Uences of EL Provisions or Just an Over Broad Provision?

The provisions of EL are contained in Chapter VIII (containing Section 163 to Section 180) of the Finance Act, 2016 (**"FA, 2016"**), as a separate, self-contained code, not forming part of the Income-tax Act, 1961 (**"ITA"**). Section 163 of the FA, 2016 provides that provisions of Chapter VIII shall *inter-alia* apply to consideration received or receivable for e-commerce supply or services made or provided or facilitated on or after April 1, 2020. In contrast, the charging provision, Section 165A of the FA, 2016 provides that Expanded EL shall apply on the amount of consideration received or receivable by an e-commerce operator from e-commerce supply or services. Therefore, it appears that the extent and applicability of Expanded EL (as provided under Section 163) is narrower and is limited to consideration received for e-commerce supply or services rather than consideration received from e-commerce supply or services (as contained in the charging Section 165A).

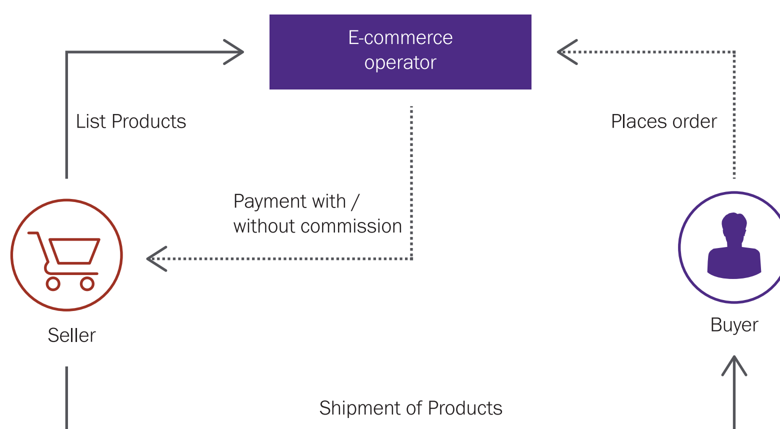
The difference in language used and therefore the scope of the provisions can be explained better through an example. In a situation where a 3rd party seller sells a good over a platform for INR 100 and the commission of the platform operator is INR 5, the consideration received for an ecommerce service provided or facilitated by the platform operator should be INR 5. The consideration received by the e-commerce operator, assuming that they are responsible for handling the payment settlement, from the e-commerce supply facilitated by them should be INR 100.

However, as set out above, the EL chapter applies only to consideration received *for e-commerce* supply and not **from e-commerce** supplies. To that extent the charging provision and the deeming fiction are broader than the scope of the EL chapter itself. Therefore, to that extent the charging provision is arguably inapplicable.

C. Case Studies

We have examined the potential implications of the proposed definition of 'consideration received or receivable' on the basis of the following case studies to further illustrate the impact:

Case Study 1 - Marketplace Model



In case study 1, the e-commerce operator is facilitating supply of goods between the buyer and seller. The payment mechanics of the transaction and applicability of Expanded EL are elaborated below:

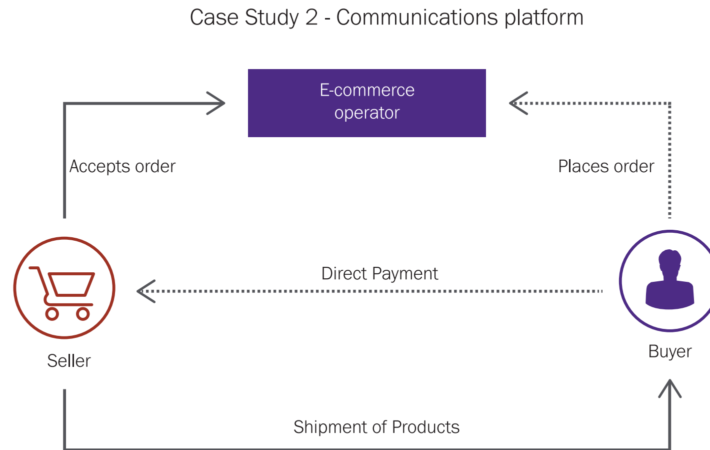
a. **E-commerce operator charging commission from buyer / seller or both:** In this case, the buyer makes payment to the seller through the e-commerce operator. On receipt of payment (say INR 100), the e-commerce operator deducts its commission (say INR 5) and pays the remaining amount to the seller (INR 95). Prior to the proposed amendment by the Finance Bill, even on the wordings of Section 165A it was possible to argue that the e-commerce operator was liable to pay Expanded EL only on the amount of consideration (INR 5). However, post the amendment by Finance Bill, the e-commerce operator would be liable to pay Expanded EL on the entire consideration (INR 100) as the definition deems to include consideration for sale of goods irrespective of whether the e-commerce operator owns the goods.

b. **E-commerce operator not charging commission from buyer / seller or both:** In this case, the buyer makes payment to the seller through the e-commerce operator. On receipt of payment for sale of goods, the e-commerce operator pays the entire amount to the seller (INR 95) without deducting any commission. Prior to the proposed amendment by the Finance Bill, it was possible to argue that the e-commerce operator was not liable to pay Expanded EL as there is no consideration for e-commerce supply or services.

However, post the amendment by Finance Bill, the e-commerce operator may be liable to pay Expanded EL on the entire consideration (INR 95) as the definition deems the term ‘consideration received’ to include consideration for sale of goods irrespective of whether the e-commerce operator owns the goods. While the intention appears to have been to cover gross payments, the current reading of the provision (explained further below in the next example) potentially goes beyond that to cover situations where consideration is not received by the E-commerce operator at all.

This is a significant issue since the whole objective of EL was to target the incomes of non-resident platforms which were going untaxed in India. In the above situation, there is no income of the platform to be taxed in the first place. To further, impose the burden of effectively paying taxes on behalf of the seller of the goods, is unreasonable and absurd. This becomes even more pronounced when we take the case of a communication platform as set out below.

Case Study 2 - Communications platform



In case study 2, the e-commerce operator is primarily a communications platform and not a marketplace which is set up primarily to encourage and facilitate sales on its platform. The buyer connects with the seller through the communications platform (which can either be through messaging, email or directly through the portal).

The buyer places order for the products through the communications platform. In such a situation, let us assume that two users message each other with respect to a transaction and the payment is made directly by the buyer to the seller through a 3rd party payment service provider which is outside the communications platform. Prior to the proposed amendment by the Finance Bill, it was possible to argue that the communications platform was not liable to pay Expanded EL as there is no consideration for e-commerce supply or services. However, post the amendment by Finance Bill, it is unclear whether Expanded EL would apply despite the fact that the communications platform does not receive any consideration. This is because the language used in the explanation states as follows: *"consideration received or receivable from ecommerce supply or services shall include –*

i. *consideration for sale of goods irrespective of whether the e-commerce operator owns the goods;*

ii. *consideration for provision of services irrespective of whether service is provided or facilitated by the ecommerce operator"*

It is important to note that the deeming fiction firstly relates to consideration received from and not for supply or facilitation of ecommerce supply. Secondly, the deeming fiction states that the term "consideration received" shall include the value of the underlying sale or service that is facilitated. The intent is clear when the marketplace is charging INR 5 and the underlying supply is INR 95 since in such a case the EL may be payable on INR 100.

However, with respect to the term *"consideration received"*, in the total absence of consideration in the above example, it may be possible to argue that the communication platform may not be liable to pay Expanded EL since there is no consideration received in the first place. This is particularly true in situations where the payment is not processed or settled by the platform and is instead done by a third party payment service provider.

Nevertheless, since the deeming fiction appears to extend to the term "consideration received" and deems it to include the value of the underlying service or sale, it is possible that tax authorities take the view that even in situations where no money is paid to or passes through the platform, EL at 2% needs to be deducted. Such a situation would be particularly unfair to such platforms since they may not even be aware that a transaction took place or what the value of the transaction is or have any ability to collect and pay the EL. Ultimately, any such imposition would be a tax on the sellers income and not the platform's and therefore the platform should not be saddled with any such burden.

Further, it is trite law that the law does not compel a man to do what he cannot possibly perform.[64] In this regard, Courts have also held that the law of impossibility of performance does not necessarily require absolute impossibility, but also encompasses the concept of severe impracticability.[65] Given that the buyer makes the payment to the seller directly and no consideration flows through the communications platform, one could argue that Expanded EL should not be applicable.

Having said this, given the construct of the EL provisions and the broad manner in which the proposed definition of consideration received or receivable is worded, it may be possible that the tax authorities argue that the communications platform is liable to pay Expanded EL on the value of the underlying transaction.

Given the magnitude of the proposals, it is imperative that necessary changes are made to avoid unintended consequences and reduce unnecessary hardship.

– **Arijit Ghosh, Ipsita Agarwalla, Meyyappan Nagappan & Parul Jain**

64. Krishnaswamy S. Pd. v. Union of India [2006] 281 ITR 305

65. National Aviation Co of India v. Deputy Commissioner of Income-tax, TDS ITA No. 6698 (Mum) of 2002

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March 8, 2021

II. Impact and analysis of the Supreme Court decision on characterization and taxation of software payments

In a landmark ruling, the Supreme Court of India (**"SC"** or **"Court"**) while ruling in favour of the taxpayers has put to rest the controversy on characterization of payments made by Indian residents for use / resale of computer software (**"Judgement"**).[66] The SC held that the amounts paid by resident Indian end-users / distributors to non-resident computer software manufacturers / suppliers, as consideration for the resale / use of the computer software through End-user Licensing Agreements (**"EULAs"**) / distribution agreements, is not the payment of royalty for the use of copyright in the computer software, and that the same does not give rise to any income taxable in India. Accordingly, the SC concluded that the person referred to in section 195 of the Income-tax Act, 1961 (**"ITA"**) is not liable to withhold tax.

The SC in the batch of 103 appeals under the Judgement, while setting aside the ruling of the High Court of Karnataka in case of *CIT vs Samsung Electronics Co. Ltd*[67] (**"Samsung"**) allowed the appeals from the impugned judgement. The SC also set aside the ruling of the Authority of Advance Rulings (**"AAR"**) in case of *Citrix Asia Pacific Ptyl. Ltd., In Re* (**"Citrix Asia"**)[68]. Lastly, the SC dismissed the appeals from the impugned judgements of Delhi High Court.[69]

A. Background

The ITA contains separate rules for the taxation of residents and non-residents. As per section 4 read with section 5 of the ITA, non-residents are taxable only on India-source income i.e., only and to the extent that such income accrues or arises or is deemed to accrue or arise in India or is received or deemed to be received in India.

Section 9(1)(vi) of the ITA *inter-alia* provides that income by way of royalty payable by an Indian resident would be deemed to accrue or arise in India if the royalty is for the purpose of earning any income from any source in India. Explanation 2 to section 9(1)(vi) defines "royalty" to be a consideration for the transfer of all or any rights (including the grant of a license) in respect of any copyright. In 2012, Explanation 4 was inserted in Section 9(1)(vi), purportedly, to clarify that the "transfer of all or any rights" in respect of any right, property or information included and had always included the "transfer of all or any right for use or right to use a computer software".

Section 195 of the ITA obligates any person making a payment to a non-resident for any sum chargeable under the ITA to deduct income-tax at source (**"TDS"**) at the time of payment. Further, as per the provisions of section 90(2) of the ITA, the taxability of a non-resident in India is governed by the provisions of the ITA or the tax treaty entered between India and the country of residence of the non-resident, whichever is more beneficial to such non-resident taxpayer.

66. 2021 SCC OnLine SC 159

67. (2012) 345 ITR 494

68. (2012) 343 ITR 1 (AAR)

69. Some of the significant Delhi High Court's decisions being appealed include *Director of Income Tax v. Infrasoft Ltd.*, (2014) 264 CTR 329; *Director of Income Tax v. Ericsson A.B.*, (2012) 343 ITR 470; *CIT v. ZTE Corporation*, (2017) 392 ITR 80; *Director of Income Tax v. Nokia Networks OY*, (2013) 358 ITR 259

The controversy surrounding the taxation of payments for software concerns the characterization of income in the hands of non-resident taxpayers as either royalties or business profits (subject to tax in India only if the profits are attributable to the recipient's permanent establishment in India). Whereas the Revenue successfully contended in some cases[70] that the consideration paid by resident Indian end-users / distributors to non-resident computer software manufacturers / suppliers software constituted "royalty", the taxpayers were successful in pleading the contrary position in some other cases.[71] The decisions of these subordinate courts were appealed by the aggrieved parties before the SC. The SC grouped these appeals into four categories based on the business model as under:

Category 1: Software purchased directly by an end-user from a non-resident supplier.

Category 2: Software purchased from a non-resident supplier by an Indian distributor and resold to Indian endusers;

Category 3: Software purchased from a non-resident supplier by a non-resident distributor and resold to Indian distributors or end-users

Category 4: Software sold as integrated hardware unit by non-resident suppliers to Indian distributors or end-users.

B. Our Analysis on Findings of The SC

i. Findings in relation to the withholding tax provisions:

The SC noted the construct of ITA and basis section 90(2) of the ITA held that once a tax treaty applies, the provisions of the ITA would not apply unless they were more beneficial to the taxpayer.[72] Further, it noted that the definition of a particular term under the ITA would be applicable only when the said term is not defined in the tax treaty. The Court also held that the TDS obligation under section 195 of the ITA is inextricably linked with the charging provisions under sections 9 and 4 of the ITA read with the tax treaty. Hence, the TDS obligation on the payer would only arise if the recipient is liable to pay income tax in India.

The Court distinguished the current dispute from its ruling in *PILCOM v. CIT, West Bengal-VII*[73], wherein it was held that the provisions of the tax treaty would have no relevance in determining the obligations of the payer under section 194E of the ITA. The Court noted that whereas *PILCOM* dealt with section 194E and similar sections which provide for tax deduction at source on specific payments that are defined under the ITA, section 195 provides that tax must be deducted at source on "any sum chargeable under the act". In order to determine the chargeability under the ITA, the payer would have to consider the provisions of the relevant tax treaty. Hence, the Court held that *PILCOM (supra)* dealt with a different nature of sections that would not have any application to the facts of the relevant case.

The observations of the SC are on point. The Court has re-iterated age old principles of taxation under ITA and interplay of ITA with tax treaties. The manner in which the Court has distinguished this case with the PILCOM ruling should provide certainty to taxpayers that the reasoning under PILCOM would not be used arbitrarily against the taxpayers. Having said this, it is unclear as to why the provisions of tax treaty, being more beneficial would not apply in the context of withholding under section 194E and similar sections. Some questions also arise given that the Court itself held that the provisions of the tax treaty would be relevant at the stage of withholding

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70. See *CIT v. Samsung Electronics Co. Ltd.*, (2012) 345 ITR 494; *CIT v. Synopsis International Old Ltd.*, ITA No. 11-15/2008; *Citrix Systems Asia Pacific Ptyl. Ltd.* (2012) 343 ITR 1 (AAR)
71. See *Director of Income Tax v. Infrasoft Ltd.*, (2014) 264 CTR 329; *Director of Income Tax v. Ericsson A.B.*, (2012) 343 ITR; *Dassault Systems K.K.*, (2010) 322 ITR 125 (AAR); *Geoquest Systems B.V. Gevers Deynootweg.*, (2010) 327 ITR 1 (AAR)
72. The Court relied on its ruling in *Union of India v. Azadi Bachao Andolan,* (2004) 10 SCC 1.
73. 2020 SCC Online SC 426

of TDS by the resident payer. The Court observed that two absurd consequences would follow if the payer were not allowed to consider the effect of the tax treaty. *Firstly*, the payer may make an excess payment, the refund of which would only be available to the recipient at the stage of its assessment. Secondly, the treaties impose a cap on the tax rate that the recipient could be charged with in the contracting state (India).

However, the payer would have to deduct tax at the rate under the ITA which may be higher than the cap under the tax treaty. As a result, the tax deducted by the payer would be a larger sum than the tax that is ultimately payable by the recipient. On this basis, the Court held that a person making a payment to a non-resident would be liable to deduct tax only if the non-resident is liable to pay tax under section 195, and in case of such liability, the person would be liable to deduct tax at the rate in the tax treaty. While the language of section 194E and similar sections in the ITA is different from that of section 195, it is not clear why the same principles of tax treaty should not be applicable to such sections as well.

ii. Classification of transaction based on provisions of the Copyright Act, 1957

The SC analyzed the provisions of the Copyright Act, 1957 (**"Copyright Act"**) in detail while coming to the conclusion that payment for the resale / use of the computer software through EULAs / distribution agreements, is not the payment of royalty. At first, the Court noted that while the term "copyright" is not expressly defined under the definitions section, section 14 of the Copyright Act makes it clear that a copyright is an exclusive right to do or authorize the doing of certain acts in respect of work (which includes literary work and hence, computer software).

Copyright is an exclusive right, which is negative in nature, being a right to restrict others from doing certain acts. A transfer of copyright would take place only when the owner of the copyright parts with the right to do any of the acts mentioned in section 14 of the Copyright Act. Such transfer is different from transfer of ownership of the material substance in which the copyright subsists, since there would no transfer of right to reproduce the copy or to do any other acts under section 14. The Court also observed that the "right to reproduce" and the "right to use" computer software are two distinct rights as the former would involve a transfer of copyright.[74] The Court held that no copyright would exist in India outside the provisions of the Copyright Act.

The Court note that the "license" that is granted vide the EULA, is not a license in terms of section 30 of the Copyright Act, which transfers an interest in all or any of the rights contained in sections 14(a) and 14(b) of the Copyright Act, but is a "licence" which imposes restrictions or conditions for the use of computer software. Use of the term "license" in an EULA / distribution agreement would not be conclusive of its real nature and the agreement must be looked into as a whole. A non-exclusive, non-transferable "license" that only enables use of the copyrighted product, with imposition of restrictive conditions on use of the product, could not be construed as a license under section 30 to do the acts enumerated in section 14 of the Copyright Act. Further, Section 52(1)(aa) of the Copyright Act provides that making a copy of the software for utilization as well as a backup copy for temporary protection by the lawful possessor would not constitute infringement of copyright. In this regard, the Court observed that it would make no difference if the end-user used general software or software customized to its specifications.

The counsel for revenue department had argued that the doctrine of first sale/principle of exhaustion would have no application as the doctrine was not statutorily recognized in section 14(b)(ii) of the Copyright Act.[75] In this regard, the SC dismissed the argument by stating that the doctrine of first sale/exhaustion doctrine has been statutorily recognized in the Copyright Act and is applicable to the case of the distributor or reseller. The shrinkwrapped copies of the computer programmes are already put in circulation by foreign, non-resident suppliers / manufacturers, since they have been sold and imported into India via distribution agreements, and

74. The Court relied on its ruling in State Bank of India v. Collector of Customs, (2000) 1 SCC 727

75. The ASG relied on the judgement of Single Judge of Delhi High Court in case of John Wiley & Sons Inc. v. Prabhat Chander Kumar

are thus not hit by section 14(a)(ii) of the Copyright Act. The SC also took note of a decision by the European Court of Justice (**"ECJ"**)[76] wherein the ECJ had concluded that the transfer of a copy of a computer programme, accompanied by the conclusion of an EULA constituted a "first sale... of a copy of a program" within the meaning of the EC Directive 2001/29. The SC held that the distribution right subsists with the owner of copyright to issue copies of the work to the public, to the extent such copies are not copies already in circulation, thereby manifesting a legislative intent to the doctrine of first sale/principle of exhaustion. On this basis, the Court held that the Copyright Act only prohibited reproduction and subsequent sale of a copy of the licensed copy, and not the resale of the copy.

The SC took note of the observations under the impugned judgements in detail. The SC set aside the ruling of AAR in case of *Citrix Asia (supra)* by stating that the license for the use of a product under an EULA cannot be construed as the license under section 30 of the Copyright Act, as such EULA only imposes restrictive conditions upon the end-user and does not part with any interest relatable to any rights mentioned in sections 14(a) and 14(b) of the Copyright Act. The SC also set aside the ruling of Karnataka High Court in case of *Samsung (supra)* on the same ground. The SC also held that the ruling of Karnataka High Court in case of *CIT v. Synopsis International Old Ltd.*[77] does not state the law clearly.

The SC upheld the ruling of AAR in case of *Dassault Systems, K.K.*, In Re[78] wherein the AAR made correctly distinguished between the ownership of copyright in a work from the ownership of the physical material in which the copyrighted work may happen to be embedded. The SC also gave its blessing to decision of AAR in case of *Geoquest Systems B.V. Gevers Deynootweg, In Re.*[79] and decisions of Delhi High Court in case of *DIT v. Ericsson A.B.*[80], *DIT v. Nokia Networks OY*[81], *DIT vs. Infrasoft*[82] and *CIT vs. ZTE Corporation*[83].

ii. Sale of goods vs license of copyrighted article

The detailed and intricate analysis of the provisions of the Copyright Act by the Court is commendable. While the findings of the SC in relation to the Copyright Act are very important, it seems that the Court's findings are not entirely clear on whether the software license being granted on a physical CD is a sale of a copyrighted article i.e. sale of goods (with certain necessary rights to use software to enable the proper use of program) or a license / right to use copyrighted article. Certain observations in *Tata Consultancy Services vs State Of Andhra Pradesh*[84] make it clear that the law does not make any distinction between tangible property and intangible property.

A software therefore which is has the following properties such as (a) its utility; (b) capable of being bought and sold; and (c) capable of transmitted, transferred, delivered, stored and possessed should be treated as goods irrespective of the medium it is stored on. The Court in *Tata Consutancy* and in other judgments relating to sales taxes have historically held that once the software is embedded onto a medium such as a CD it becomes a marketable good.

In a world that has moved away from CDs to digital downloads, where the content and licence terms with respect to a software remain the same, drawing this distinction appears to be artificial and potentially the incorrect way of

76. UsedSoft GmbH v. Oracle International Corp. (Case C-128/11)
77. ITA Nos. 11-15/2008
78. (2010) 322 ITR 125 (AAR)
79. (2010) 327 ITR 1 (AAR)
80. (2012) 343 ITR 470
81. 2013) 358 ITR 259
82. (2014) 264 CTR 329
83. (2017) 392 ITR 80
84. https://indiankanoon.org/doc/153638/

looking at categorising this transaction. If this distinction were to be drawn then a software that is licensed digitally will be treated differently from a software that is sold on a CD even though the licence terms are the same.

The Judgment in the current case does not resolve this inconsistency wholly. It treats the consideration to be for sale of goods as some places and to be for license / right to use copyrighted article at other places.

Illustratively, the SC quotes *"when, under a non-exclusive license, an end-user gets the right to use computer software in the form of a CD, the end-user only receives a right to use the software and nothing more"*, at one place. This is perhaps the correct way to look at the transaction wherein the copy of the software on the CD is a good in respect of which the right to use is provided in the terms of the license. Therefore, the transaction may be more appropriately classified as a right to use a copyrighted article, irrespective of whether it is on a CD or otherwise since a right to use an intangible good should not be treated as a sale of the same good merely because it is now embedded on a physical object.

In contrast, at another place the Court notes that *"what is paid by way of consideration, therefore, by the distributor in India to the foreign, non-resident manufacturer or supplier, is the price of the computer programme as goods, either in a medium which stores the software or in a medium by which software is embedded in hardware, which may be then further resold by the distributor to the end-user in India, the distributor making a profit on such resale."* It clearly states that *"What is "licensed" by the foreign, non-resident supplier to the distributor and resold to the resident end-user is in fact the sale of a physical object which contains an embedded computer programmed".*

The Court then treats the license terms are necessary to enable the proper use of the goods sold in such a situation.

The Court has technically only dealt with software on a CD format or in tangible format. However, in a digital license no title is being given in relation to the software or the copy of the software or any tangible good and therefore arguably it should not be categorized as a sale. In the CD example, the Court has perhaps mistakenly conflated transfer of title to the CD/tangible property as the sale with the license or right to use of the software on the CD under the license agreement. Whether it's a sale or license should not depend on whether software is on CD or not. It should depend on whether title is being transferred in relation to the copyrighted article or good, which is the software and should not arise when there is only a right to use a good being granted under the license agreement. The software companies would also want to treat this as a license/right to use and not a sale since from a copyright protection perspective, since a sale indicates greater rights to the end-user and that is the intent with which many restrictions are laid down in the license agreement. While it may have been difficult to move away from the sales tax cases that have treated these as sale of goods in the past, this may prove to be a lost opportunity in a judgment that has otherwise brought a lot of clarity and relief to taxpayers.

The Court has relied on rulings in relation to customs laws and copyright laws to classify this transaction and the potential impact of this distinction is examined in the latter part of this hotline.

iii. Findings in relation to definition of royalty under the ITA vis-à-vis tax treaty

The Court compared the definition of "royalties" under the relevant tax treaties with definition under the ITA. It observed that the tax treaty provides an exhaustive definition and includes any kind of payments received as consideration for the "use of" or "right to use" any copyright in a literary work. The Court observed that the definition under the ITA was wider as it included a lumpsum consideration that would not be considered income of the recipient under the head "capital gains"; expressly includes a grant of license when it speaks of "transfer of all or any rights"; and states that such transfer should be "in respect of" any copyright of a literary work. With respect to the third difference, the Court observed that the phrase "in respect of" is equivalent to "on" or "attributable to" and could not be understood as an expansion of the definition of royalty. The Court held that that there is no difference between the two definitions to the extent that the transfer of all or any rights or grant of a license for the copyright is a *sine qua non* for a transaction to constitute payment for royalty under these definitions.

The taxpayers had argued that explanation 4 does not expand the scope of royalty under explanation 2 to section 9(1)(vi) of the ITA. The Revenue had argued that explanation 4 to section 9(1)(vi) was only clarificatory in nature and outlined the position of law that had been followed since 1976. The Court rejected the taxpayers' submission and held that explanation 4 to section 9(1)(vi) did expand the scope of royalty under explanation 2 to section 9(1) (vi). The Court also rejected the Revenue's submission and held that the position of law relating to computer software under explanation 4 could not possibly have existed since 1976.

It observed that the concept of "royalty" itself was introduced in 1976 under the ITA, that the term "computer software" was introduced to section 9(1)(vi) for the first time in 1991, and that the term "computer software" in the context of a literary work under the Copyright Act was only introduced in 1994. The Court held that it would be ludicrous to expect that the amendment which introduced explanation 4 to apply retrospectively since 1976, when the concept of computer software was not even introduced to the relevant provisions. The Court extended this finding to explanation 6 to section 9(1)(vi) that was introduced through the same amendment, on the basis that technology relating to satellites, optic fibre, and similar technology was first regulated in 1995, much after the date of retrospective application in 1976.

iv. Impossibility defense reinforced with respect to tax withholding obligations

On the question of retrospective application, the Court also held that the payer could not be expected to do the impossible and deduct tax at source during a time when the obligation did not factually exist in the statute.[85] Hence, a person making a payment to a non-resident could not be held as an "assessee in default" for not deducting tax on payments since 1976, before the obligation to deduct tax on such transactions even existed in the statute. It is trite law that the law does not compel a man to do what he cannot possibly perform.[86] The reiteration of the principle of impossibility by the SC should also help taxpayers in arguing non-applicability of other withholding tax provisions (like section 194-O) where arguably in many situations marketplaces are not in a position to comply with the requirements therein.

v. Observations in relation to interpretation of tax treaties

The SC made some very interesting observations on interpretation of tax treaties. At the outset, the SC held that tax treaties entered by India should be interpreted liberally with a view to implement the true intention of the parties.[87] The Court noted the importance of the Commentary on Article 12 of the OECD Model Tax Convention (**"OECD Model"**) and held that the Commentary on OECD Model would have persuasive value with respect to the interpretation of the term "royalties". The Court held that the payers and recipients have a right to know their position and obligations under a treaty and that they could place reliance on the OECD Commentary to understand the same. Further, India's reservations to the commentary would not affect its relevance unless the reservations were incorporated into the treaties through bilateral negotiation with the respective countries. The Court noted that India had entered or amended tax treaties with different countries after expressing its reservation, yet the definition of royalty had not been changed and remained similar to the definition in the OECD Model.

Hence, its reservation would not apply as it had not been incorporated in any tax treaty. Therefore, the Court has correctly relied on state practice to determine the interpretation of treaty provisions using the correct application of international law principles instead of relying upon the mere assertions of the counsel for the tax department.

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85. The Court relied on *Arjun Panditrao Khotkar v. Kailash Kushanrao Gorantyal*, (2020) 7 SCC 1; CIT v. NGC Networks (India) Pvt. Ltd.,
86. Krishnaswamy S. Pd. v. Union of India [2006] 281 ITR 305
87. The SC relied on the decision in case of Azadi Bachao Andolan

More importantly, the above observations of the SC have reinstated the sanctity of the OECD Commentary. The Court has clearly set out the relevance and importance of OECD commentary and in fact goes to say that not only due to VCLT, but in case of conflicting municipal decisions, taxpayers can rely on OECD commentary which may be helpful for tax issues which may arise in future as well. The Court observed that recommendatory changes or reservations expressed by the Indian executive would not affect the application of the tax treaties unless the changes are incorporated therein. This requirement of bilateral negotiation and incorporation of changes protects taxpayers from being adversely affected by the unilateral position taken by the Government.

This should definitely bring certainty for taxpayers wherein tax treaties mostly follow mode commentary and reduce possibility of conflicts in future. The fact that the SC has held that tax treaties should be interpreted to implement the true intent of the parties can also help taxpayers in interpretation provisions of the multilateral instrument (**"MLI"**). By virtue of these observations, the explanatory statement of the MLI may have more significance now and international practice is likely to be accorded more weight if domestic courts are taking divergent views.

C. Conclusion and Next Steps

The Judgement definitely comes as a respite for the taxpayer community and settles a long-drawn historical dispute.

It is likely to impact several technology companies and distributors / re-sellers in India.

Application of refunds: The taxpayers should first and foremost revisit their positions for royalties paid in the past and apply for refunds, wherever possible and applicable. While the claim of refund can be substantiated basis the Judgement, the taxpayers may now have to assess applicability of equalization levy (**"EL"**) on such transactions. *Applicability of EL:* While the Judgement settles the issue on characterization as royalty and taxability under the provisions of ITA, the taxpayers will now be posed with another question regarding the applicability of the EL on such transactions.[88] The issue is further exacerbated by the clarification proposed to be inserted by the Finance Bill, 2021 (**"Bill"**). As per the clarification proposed by the Bill, if the consideration received for sale of software is not taxable as royalty under the ITA, read with the relevant tax treaty, then such consideration could be taxable under the EL provisions. Due to the proposed amendment by the Bill, taxpayers may find themselves claiming refund of tax paid on royalty, on one hand and paying / contesting applicability of EL on the other hand.

Reviewing pending litigations: Taxpayers may also consider to review their pending litigations where they are relying on treaties based on the OECD Model. The principles laid down by the SC on interpretation of tax treaties and on the sanctity of the Commentary on OECD Model, they can now further bolster their positions and strengthen their case. It is not unusual for several divergent rulings by different tax tribunals on international tax cases and this could be a good reason to reassess approaches in those cases.

FDI: As elaborated above, the Court has relied on cases under Customs law, Copyright Act etc. to characterize the transaction. In this regard, Indian entities with foreign investment engaged in e-commerce with respect to 'sale of goods' may also re-check their compliance with FDI rules. Typically, e-commerce in services is not an issue under FDI rules and if an entity is dealing only with licensing or providing the right to use with respect to software in wholly digital format, it is unlikely to face any problems. However, if the entity is selling the same software on a CD format or tangible format, then whether it would amount to e-commerce in goods as an inventory model is something companies should assess and verify at the soonest as there are restrictions around the same.

Database Subscriptions: Subscription to databases have sought to be classified as royalty payments by the tax department and while this ruling does not touch upon those issues, but similar principles should apply. The

88. The EL was introduced under the Finance Act, 2016. The scope of the EL was expanded by the Finance Act, 2020 to apply EL at rate of 2% on e-commerce operators on e-commerce supply or services to specified persons

end user who pays for accessing databases is not paying for the 'transfer' of any underlying copyright but is rather paying for a digital service that allows them to access the database. It is therefore only a right to use the copyrighted articles on the database for a limited period of time.

Reliance on Treaty Benefits: While the Court seems have indicated that there is no difference between ITA and DTAA in terms of the scope of the definition of royalty, for other businesses since this distinction was heavily reliant on copyright act they may still need to consider the availability of treaty relief as an additional protection.

GST: From a GST perspective, there is unlikely to be any additional impact on domestic transactions since both supply of software on a CD as a good or supply of a software as a right to use under a license agreement would both be covered. However, from a cross border perspective, the treatment of the transaction as an OIDAR service or a sale of a good could have significant implications. Particularly, if we take the example of a digitally downloaded software that is akin to a digital good, the point of taxation rules state that GST applies only when customs is paid on the import of a good. However, no customs is imposed today on crossborder imports of digital softwares. Therefore, if classified as a sale of a good, GST is unlikely to apply. However, if the same transaction is seen as a mere right to use and is construed as a service or an OIDAR service under the terms of the license agreement, then GST is likely to apply.

– **Ipsita Agarwalla, Meyyappan Nagappan & Parul Jain**

February 1, 2022

III. India Budget 2022: Decrypted

A day before, the Indian Finance Minister (**“FM”**), Nirmala Sitharaman, presented the Union Budget (Budget) of India for the financial year (**“FY”**) 2022-23. With India’s economic growth in the current year estimated to be 9.2% (highest among all large economies), the Budget focuses on promotion of the digital economy, clean energy, climate action and private investment with public capital investment.

On the reforms, the Budget proposes to introduce a trust-based governance for ease of doing business in India. In this regard, the Budget has announced that necessary amendments to the Insolvency and Bankruptcy Code, 2016 will be carried out to increase the efficiency of the resolution process and facilitate cross-border insolvency resolution along with reduction in time period for the voluntary winding up of companies from 2 years to 6 months. Further, acknowledging the extent of private equity and venture capital investments in the start-up eco-system, the Budget has announced that an expert committee would be set up to holistically examine the regulatory hurdles and other frictions that prevent further scaling up of such investments. The private equity and venture capital industry has for long been demanding clarity on applicability of GST and income tax on carried interest. Hopefully, with the set up of the expert committee, some of these issues may get resolved. After liberalising the drone sector through the Drone Rules, 2021,[89] the Budget proposes to provide a boost to the drone industry. Start-ups will be promoted to facilitate the Drone Shakti project through varied applications for use of drones as a service (DrAAS). As an independent initiative, the use of Kisan drones in public-private partnerships will also be encouraged for delivery of digital and high-tech services to farmers including crop assessments, spraying of insecticides and nutrients. This should hopefully result in the development of agri-tech for the Indian agriculture sector. The government will also facilitate a fund with blended capital raised under co-investment models through NABARD to finance start-ups for agriculture and rural enterprises.

Further, in light of the space constraints in urban areas for setting up charging stations, a battery swapping policy is proposed to be introduced, and interoperability standards will be formulated to enable this policy. This will encourage private players to develop innovative business models for “battery as a service”. The proposed battery-swapping policy and special mobility zones are welcome moves to enable the shift towards sustainable mobility and promote the EV sector.

Furthering the Government’s agenda on digitalising the Indian economy, some of the key announcements include introduction of a central bank digital currency, a digital university for enhancing access to educations to students across the country, rolling out the National Digital Health eco-system, which inter-alia, comprises of the unique health identity and launching of the National Tele-Mental Health program to provide quality mental health counselling to the people.

To encourage Defence R&D, the Government also plans to allow design and development of military platforms and equipment to be taken up by private industry in collaboration with Defence Research and Development Organisation (**“DRDO”**). For this purpose, an independent nodal umbrella body will be set up for meeting wide ranging testing and certification requirements.

On the direct tax front, the most significant proposal is the taxation of virtual digital assets. The Budget proposes to tax transfer of virtual digital assets at the rate of 30% irrespective of the period of holding and does not allow for any deduction in respect of expenses incurred aside from the cost of acquisition. Further, gift of such assets will

89. The Drone Rules, 2021, available at: https://egazette.nic.in/WriteReadData/2021/229221.pdf (Last accessed on February 01, 2022).

be taxed in the hands of the recipient. Additionally, loss from transfer of such assets cannot be set-off against any other income. Tax is also be withheld at the rate of 1% on the transfer of such assets in certain cases.

Tax rates largely remain unchanged. However, surcharge on income tax for co-operative societies has been capped at 15% to provide them with a level playing field with companies. Further, the surcharge on long term capital gains on transfer of any type of asset (including unlisted shares) has been capped at the rate of 15%, that is, on par with that of listed shares. Additionally, dividends received by Indian companies from their foreign subsidiaries is proposed to be increased to the rate of 30% instead of the current rate of 15%. Further, the Finance Bill, 2022 (**"Finance Bill"**) proposes to levy withholding tax on perquisites provided to Indian resident taxpayer at the rate of 10% of the value of the perquisite.

For eligible start-ups established before March 31, 2022, a tax holiday for 3 consecutive years out of 10 years from the incorporation date was provided. In response to the Covid-19 pandemic, the Budget proposes to extend this benefit to start-ups incorporated prior to March 31, 2023. Additionally, the concessional tax regime of 15% to manufacturing companies was available should such companies commence manufacturing by March 31, 2023; this date has now been extended to March 31, 2024.

In an effort to streamline the process for tax litigation, certain measures have been introduced to avoid repetitive appeals by the department in the higher courts. This is a positive step towards an efficient litigation resolution framework. Further, the Budget proposes to provide an ability to taxpayers to rectify any errors in their tax return within a period of 2 years from the end of the relevant assessment year.

In a welcome move, the Budget also proposes that where an income tax liability has been modified by an order of an Adjudicating Authority under the Insolvency and Bankruptcy Code, 2016, the Assessing Officer shall modify the demand payable in conformity with such order. This would result in removal of an anomaly whereby there was no mechanism or procedure to reduce the income tax liability to give effect to such orders.

Pursuant to various judicial pronouncements on successor liability, the Budget proposes to introduce a new deeming fiction in the case of a 'business reorganization' wherein the assessments/proceedings (whether pending or completed) on the predecessor entity made during the course of pendency of the scheme/reorganization, are deemed to have been made on the successor.

Developments in relation to the GIFT City include setting up of foreign universities and an international arbitration centre. On the tax front, tax exemption has been proposed for income of a non-resident from offshore derivative instruments, or over the counter derivatives issued by an offshore banking unit, income from royalty and interest on account of lease of ship and income received from portfolio management services in IFSC. Separately, the Budget proposes to replace the Special Economic Zone Act with a new legislation. However, the fine print of the new legislation is awaited.

A slew of changes has also been made to the scheme under the Income Tax Act, 1961 (ITA) for charitable organisations, search and seizure related provisions, faceless assessment, allowability of expenditure for the purposes of business or profession and penalty related provisions.

In summary, while this Budget focuses on digitalisation of the Indian economy, it has missed to address number of other key issues such as rules on offshore listing for Indian companies, creating regulatory regime conducive for Special Purpose Acquisition vehicles (SPACs), reduction in tax rates for the salaried / middle class, concessional tax rates for businesses engaged and investing into green technology etc. Further, taxation of virtual digital assets is expected to have a far-reaching impact on the crypto eco-system and it would be relevant to see how the Government further regulates such assets. We have provided below a more comprehensive analysis and further insights on the 2022 Budget proposals. Hope you enjoy reading it.

Taxation of Virtual Digital Assets

While the cryptocurrency space in India has been subject to regulatory resistance and ambiguity, it is has nevertheless boomed in the last year and is estimated to touch USD 241 million by 2030.[90] Indian investors hold crypto assets worth USD 5.3 billion.[91] Further, news reports suggest that India has the highest number of crypto owners in the world at 10.07 crore.[92] The boom in crypto trading can be attributed to a surge in global interest and the Supreme Court decision wherein the Supreme Court set aside, on constitutional grounds, a circular issued by the Reserve Bank of India, which had sought to restrict banking facilities from being offered to participants involved in cryptocurrency transactions. The Supreme Court ruling affirmed the virtual currency exchanges' fundamental right to trade and do business, guaranteed under the Constitution of India.

However, lack of guidance on tax regime created several open issues and grey areas for all participants in the industry. While there is no clarity on the fate of virtual digital assets (**"VDAs"**) in India on the regulatory front, the Finance Bill has proposed the much-awaited taxation regime for VDAs in India. The following changes have been proposed under the ITA with respect to taxation of VDAs applicable with effect from financial year 2022-23:

- Definition of VDA;
- Taxing income from transfer of VDAs under section 115BBH at a special rate of 30%;
- Gift tax on VDAs;
- Withholding tax provision on payments for transfer of VDA to a resident.

We have discussed these provisions in detail below.

A. Definition of VDA

The Finance Bill proposes to define VDA under section 2(47A) of the ITA. It seems that the definition of VDA under the Finance Bill has largely draws from the definition under the Draft Banning of Cryptocurrency & Regulation of Official Digital Currency Bill, 2019.[93]

The Finance Bill provides an exhaustive but broad definition of VDA where the following criteria need to be met to qualify as a VDA (irrespective of the terminology or nomenclature):

Necessary Critera:

- any information or code or number or token,
- generated through cryptographic means *or otherwise*,
- can be transferred, stored or traded electronically;

90. https://economictimes.indiatimes.com/tech/technology/crypto-tech-industry-to-grow-to-241-million-in-india-by-2030-nasscom/articleshow/86478346.cms
91. https://economictimes.indiatimes.com/tech/tech-bytes/about-20-million-indians-jumped-on-to-crypto-bandwagon-in-2021/articleshow/88628547.cms?from=mdr
92. https://www.livemint.com/market/cryptocurrency/india-has-highest-number-of-crypto-owners-in-the-world-at-10-07-crore-report-11634110396397.html
93. The Draft Banning of Cryptocurrency & Regulation of Official Digital Currency Bill, 2019 was proposed in the report of the high-level Inter-ministerial committee formed under chairmanship of Secretary, Department of Economic Affairs, to propose specific actions to be taken in relation to Virtual Currencies. The aforesaid bill was supposed to be taken up for consideration by the Lok Sabha in the winter session of the Parliament. However, the bill has not been discussed in the winter session which concluded on December 23, 2021

Additional Criteria (one of which needs to be satisfied):

- 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);

Exclusions: Indian currency or foreign currency as defined under Foreign Exchange Management Act, 1999 (**"FEMA"**)[94] is excluded from the ambit of VDA meaning that anything that is Indian currency or foreign currency is automatically not a VDA.

NFT: The definition of VDA also specifically includes a non-fungible token (**"NFT"**)[95] or any other token of similar nature, by whatever name called. While the Finance Bill includes NFTs as a separate category in the definition of VDAs, the Finance Bill provides that definition of the term NFT will be specified by the Central Government by notification. It is also pertinent to note that the Finance Bill empowers the Central Government to notify any other digital asset as a VDA or exclude any digital asset from the definition of VDA. Therefore, from the scheme of the provisions, it appears that the legislative intent is to treat NFTs as a separate class of VDA (based on definitions to be notified in the future) and not as a something that may fall within the generic criteria set out above. The rationale for such distinctive treatment is unclear for the time being and perhaps the definition of the NFT when notified shall provide more light on the matter.

i. Expansive scope

The proposed definition of VDA in the Finance Bill is very broad, and could include majority of crypto assets currently being traded online. VDAs have various use cases, although, there is no standard classification, certain authorities have classified VDAs based on their functions. For example,

1. *Payment tokens:* certain crypto assets can be viewed as payment tokens which are used as a medium of exchange or goods or services and also as a store of value (in certain cases)[96].
2. *Property Tokens:* certain tokens represent rights in property.
3. *Governance Tokens:* governance tokens allow token holders to exercise control over the ecosystem.
4. *Utility Tokens:* utility tokens facilitate the exchange of or access to specific goods or services etc.
5. *Security Tokens:* crypto assets which fulfil

94. Section 2(q) of FEMA defines Indian currency as, *""Indian currency" means currency which is expressed or drawn in Indian rupees but does not include special bank notes and special one rupee notes issued under section 28A of the Reserve Bank of India Act, 1934 (2 of 1934)"*. Further, section 2(m) of the FEMA defines foreign currency as *""foreign currency" means any currency other than Indian currency"*.
95. Explanation to section 2(47A) of the ITA provides that meaning of NFT may be defined by the Central Government through a notification in the Official Gazette.
96. Example – bitcoin, ether etc.

6. the characteristics of 'securities' as defined under securities laws (although no crypto-assets are today regulated as securities in India) are also likely to be included in the definition of VDAs. While such tokens may represent characteristics of a 'security'[97], however as per the current definition, they may be characterised as VDA only for the purpose of ITA.

The use of words 'information', 'code', 'number' makes the definition of VDA all encompassing. Further the presence of 'or otherwise' in the phrase "generated through cryptographic means or otherwise", may be interpreted to mean that even the information or code which is not generated through cryptographic means could also be covered under definition of VDA. Due to the wide definition, even credit card / debit card reward points, airline miles, digital vouchers, in-game currencies etc. could potentially be included within scope of VDA, as they may be (i) information / code / number / token generated through non – cryptographic digital means, (ii) which digitally represent value, (iii) represent inherent value or function as unit of account and (iv) transferred, stored or traded electronically. This may have unintended consequences and should be excluded from the scope of VDAs. If one were to take a liberal interpretation of the definition of VDA, dematerialised securities, specifically foreign securities that have shares as underlying security may also get covered resulting in wide ramifications.

The Finance Minister has also announced introduction of Central Bank Digital Currency (CBDC) by the Reserve Bank of India (**"RBI"**) using blockchain starting 2022-23. The CBDC issued by the RBI may also fall within the ambit of VDAs unless specifically excluded by the government.

ii. Inherent Value

One of the features in definition of VDA is providing *'..promise or representation of having inherent value...'*. As a market standard, most of the crypto assets issued are accompanied with a whitepaper detailing technical details, concept and roadmap for growth of the crypto asset. Hence, even if a crypto asset does not have inherent value on its issuance, but the issuer promises or represents (maybe through whitepaper or any offer document submitted to SEC for instance at the time of an ICO/Initial coin Offering) that such crypto asset may acquire value in future, then the crypto asset may be considered as a VDA.

At a theoretical level, there have always been criticisms that the crypto assets do not have any inherent value, hence this could be a grey area that creates interpretational issues.

iii. Interplay with 'currency'

Indian currency and foreign currency (as defined under FEMA) have been excluded from the scope of VDA. Currency has been defined under section 2(h) of FEMA as,

""currency" includes all currency notes, postal notes, postal orders, money orders, cheques, drafts, travellers cheques, letters of credit, bills of exchange and promissory notes, credit cards or such other similar instruments, as may be notified by the Reserve Bank".

97. Section 2(h) of the SCRA: ""securities"— include (i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or a pooled investment vehicle or other body corporate; (ia) derivative; (ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes; (ic) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002; (id) units or any other such instrument issued to the investors under any mutual fund scheme; Explanation.—For the removal of doubts, it is hereby declared that "securities" shall not include any unit linked insurance policy or scrips or any such instrument or unit, by whatever name called, which provides a combined benefit risk on the life of the persons and investment by such persons and issued by an insurer referred to in clause (9) of section 2 of the Insurance Act, 1938 (4 of 1938); (ida) units or any other instrument issued by any pooled investment vehicle; (ie) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be; (ii) Government securities; (iia) such other instruments as may be declared22 by the Central Government to be securities; and (iii) rights or interest in securities."

The definition of currency is an inclusive one, and it is unclear whether crypto-assets are covered within in such definition.

While the policy intent is clear that a bright line is being drawn separating currency and VDA, in practice there could be ambiguity with respect to where the demarcation between currency ends and VDA begins. Further, with the proposed introduction of CBDC and developments where countries such as El Salvador have recognised Bitcoin as its legal tender[98], it is quite likely the ambit of Indian and foreign currency may expand, excluding certain items from the scope of VDA.

B. Taxing income from transfer of VDAs under section 115BBH

The Finance Bill proposes to introduce section 115BBH to provide a special tax rate of 30% for taxing income from transfer of any VDAs. Such income shall be computed without taking effect of:

a. Any deduction in respect of any expenditure (other than cost of acquisition) incurred for such transfer; or

b. Any allowance or set off of any loss.

It is further provided that loss from transfer of VDAs shall not be permitted to be set off against income computed under any other head under the ITA. The loss shall not be allowed to be carried forward to succeeding assessment years as well.

It is pertinent to note that the tax rate of 30% is exclusive of surcharge and cess. The super-rich surcharge of 37% applicable on individuals having total income more than INR 5 crores should also be applicable to income earned from transfer of VDAs effectively taking the tax rate to 42.74%. Section 115BBH essentially puts an end to questions on characterisation of income from VDAs in so far as characterisation of such income should not matter as no deductions or set off or carry forward of losses are permitted under section 115BBH.

This is similar to the tax regime that currently exists with respect to taxation of winnings from games. The parliamentary intent appears to be to that transactions in this space are booming and hence need to be taxed at the higher rate of 30%. Prior to this amendment, it was possible to categorise transactions as either trading income and claim expenses or claim long term capital gain rate of 20% based on the facts of the case. However, this special rate of 30% shall impact trading volumes as it increases the tax burden along with the tax certainty it brings.

It is likely that the industry will see a shift in trading patterns, away from seeking arbitrage or small margin large volume trading to more investment style buying and selling from investors.

C. Gift tax on VDAs

Section 56(2)(x) is an anti-abuse provisions which deems income in the hands of the recipient, if any (i) sum of money, (ii) immovable property, or (iii) any property (other than an immovable property) is received by such recipient (i) without consideration and the fair market value (**"FMV"**) of the property exceeds INR 50,000 or (ii) for a consideration which is less than aggregate FMV of the property by an amount exceeding INR 50,000. 'Property' has been defined under explanation to section 56(2)(x) of the ITA read with sub-clause (d) to the explanation to section 56(2)(vii) as **""property"** means the *following capital asset of the assessee, namely:- (i) immovable property being land or building or both; (ii) shares and securities; (iii) jewellery….*"

98. https://www.livemint.com/news/world/el-salvador-becomes-first-country-to-use-bitcoin-as-legal-tender-11631144769412.html

The Finance Bill proposes to amend the definition of 'property' to include VDAs. The term VDA has been proposed to be defined under a new section, section 2(47A) of the ITA, and has not been included under the definition of capital asset. By virtue of the proposed amendment, any gift of VDAs should be deemed to be income in hands of the recipient subject to tax at rate of 30% (plus applicable surcharge and cess).

It is however pertinent to note that not all gifts are taxable under section 56(2)(x). Section 56(2)(x) provisions certain exemptions in case of receipt of property (i) from a relative, (ii) under will or inheritance, (iii) from any trust or charitable institution registered under ITA, etc. In such cases, receipt of VDA should also not be taxable. In the cryptoasset markets, it is a common for some crypto projects to airdrop their tokens. Airdrop can be understood as a crypto project sending free tokens en masse to their communities in a bid to encourage adoption and as a means to reward early adopters.[99] In such case, if the value of airdropped VDA exceeds INR 50,000 then it could be taxable in the hands of the recipient. For certain VDAs, one can take a view that such VDAs have been airdropped because a person has used that particular VDA's ecosystem, for which he / she may have incurred certain transaction cost as well, and hence the VDA has not been received without consideration. However, this position depend on valuation and the difference in the amounts paid for the airdropped tokens. Similarly, it is also common for crypto exchanges to issue promotional tokens to their users or offer special tokens as part of the marketing or to incentivise transactions. In case the value of such tokens exceed INR 50,000, tax implications under section 56(2)(x) may be triggered, which is a particular risk where such tokens have an independent market value and trade at a certain value on the market.

D. Withholding tax provision on payments for transfer of VDA to a resident

The Finance Bill proposes the introduction of section 194S to the ITA. Section 194S of the ITA obligates any person responsible for paying to a resident any sum by way of consideration for transfer of a VDA to withhold tax at rate of 1% at the time of payment or credit, whichever is earlier.

While the aforesaid withholding provision should technically be applicable on the buyer of VDAs and crypto exchanges (marketplace) should not be considered as 'person responsible for paying consideration', the obligation to withhold tax under section 194S may practically be on crypto-exchanges. However, with the advent of decentralised finance and evolution of smart contracts, it is possible increasingly in the future that the 'person responsible for paying consideration' may not be the exchange or the platform, in which case the buyer could directly have a tax deduction exposure.

Further, the withholding tax provision is also likely to be a deterrent to volume trading as volume trading with minimal margins may not feasible considering withholding tax cost on each trade. This is likely to be particularly acute with respect to crypto-crypto transactions where the payments would have to be converted to INR to make the TDS payment. This would create additional currency conversion rate risks or raise operational challenges where users may have to pay INR to be able to receive the crypto into their accounts.

99. https://www.coindesk.com/learn/what-is-a-crypto-airdrop/

i. Exclusions

The Finance Bill provides that no tax shall be deducted under section 194S in the following cases

a. Where the value or aggregate value of consideration payable by specified person does not exceed INR 50,000 during a financial year

b. Where the value or aggregate value of consideration payable by a person other than a specified person does not exceed INR 10,000 during a financial year

Practically, the buyer may not have the knowledge of the identity of counter party in a crypto transaction undertaken on a crypto exchange. Even if crypto exchanges were to comply with the provisions of section 194S, they will have to take details from their users to assess whether the users fall under the ambit of specified persons or not. At a practical level, assessing these details may not be possible by the buyer and hence the exchanges may have to step in based on trading data available on their platform.

ii. Payment in kind or in exchange of another VDA

Section 194S also obligates the person responsible for paying to a resident any sum by way of consideration for transfer of a VDA to ensure that tax has been paid in respect of such consideration
for the transfer of VDA in case where

i. consideration for transfer of VDA is wholly in kind or in exchange of another VDA, where there is no part in cash; or

ii. partly in cash and partly in kind but the part in cash is not sufficient to meet the liability of deduction of tax in respect of whole of such transfer

Crypto to crypto trading is very common in the crypto ecosystem. It is unclear how the withholding provisions will operate in this case. The obligation on the buyer to discharge tax in case transactions are undertaken in kind seems to be an onerous obligation on the buyers or exchanges and is likely to give rise to cash flow issues. This also creates timing issues with respect to the point in time at which the TDS is to be deducted. The section deems that a credit to the account of a user shall be deemed to be payment, which means that the INR amount for TDS payment should be available with the exchange prior to the credit of the crypto consideration to the seller's account. This would create practical challenges.

iii. Interplay with other withholding tax provisions

Section 194S specifically contains a non-obstante clause (section 194S(4)) to provide that if withholding has been undertaken as per section 194S, there should be no obligation to comply with other withholding or collection of tax at source provisions under the ITA. Despite the non-obstante clause, section 194S(8) specifically clarifies that in case where withholding tax provisions contained under both section 194-O and section 194S are applicable on a transaction, then tax should be deducted under section 194S only.

This is a welcome clarification and should put an end to doubts on applicability of section 194 O to crypto exchanges. However, the language of the actual text of the provision in section 194S is a little misleading and potentially suggests the opposite effect. Amending the language to make it clearer by adding "only" as suggested below would avoid any potential issues in the future.

"(8) Notwithstanding anything contained in section 194-O, in case of a transaction to which the provisions of the said section are also applicable along with the provisions of this section, then, tax shall be deducted [ONLY] under sub-section (1)."

iv. Power to issue guidelines

Section 194S also contains a provision for the Central Board of Direct Taxes (**"CBDT"**), with prior approval of Central Government to issue guidelines for removing difficulties in context of the said section.

While the proposed regime does not seem to be crypto investor friendly, the mere introduction and recognition of VDAs under the ITA is a welcome move for the industry. Further, while the policy intent for taxing income from VDAs similar to gambling transactions seems to stem from governments discomfort on crypto assets, it is definitely a step in the right direction. It provides clarity on several open questions from an income-tax perspective. Having said this, there are several misses and further clarifications in this regard may be useful:

a. Applicability of equalization levy (**"EL"**) on crypto-exchanges: The Finance Act, 2020 had expanded the scope of EL to apply 2% EL on the amount of consideration received or receivable by an 'e-commerce operator' from 'e-commerce supply or services' made or provided or facilitated by or through it to:

- to a person resident in India
- to a non – resident in certain specified circumstances
- to a person who buys such goods or services or both using internet protocol address located in India. (collectively as **"Specified Persons"**)

Given the broad definition of e-commerce operator and e-commerce supply or services, it may be likely that transactions in VDA by Indian users (especially buyers) on a foreign cryptocurrency exchange could be subject to EL. However, the Finance Bill has not provided any clarity on applicability of EL on foreign cryptocurrency exchanges.

b. Valuation rules: while the Finance Bill provides guidance on manner of taxation, there is no guidance on valuation of VDAs. Valuation of VDAs may be particularly complex given the volatile nature of the asset class. The value determination is particularly tricky with respect to crypto to crypto transactions where the trading rates for each crypto may vary across exchanges within a single day and there could be significant variations across regions. Therefore, determining fair market value of any crypto at a given point in time may not be possible and could lead to disputes. In many instance, this is key to determining the applicability of section 56 for example. Lack of guidance on valuation aspects may create difficulties for taxpayers to comply with the tax provisions.

c. GST provisions: Currently, there is no guidance on the manner in which GST provisions are applicable to transactions in VDAs. The Finance Bill also does not provide any clarity on GST provisions applicable on VDAs. In the recent past, the GST authorities have raided several crypto exchanges in India. [100]Lack of guidance on GST aspects may create several issues on classification of crypto transaction, determination of tax base etc. Clarity on GST provisions should be the next big item in the government's checklist to provide an effective taxation regime for VDAs.

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100. https://www.outlookindia.com/website/story/business-news-dggi-raids-half-a-dozen-crypto-exchanges-in-india-on-gst-evasion-report/407794

July 8, 2022

IV. Taxation of Crypto-assets

Emerging regime for Virtual Digital Assets (VDAs)

The Income-tax Act, 1961 (**"ITA"**) did not contain any specific provisions for taxation of virtual digital assets (**"VDA"**) until the Finance Act, 2022 (**"FA 2022"**) (coming into effect from April 1, 2022). The Finance Act, 2022 has introduced the much-awaited taxation regime for VDAs in India. Specifically, FA 2022 introduced the following:

- Section 2(47A): An expansive definition for VDA;
- Section 115BBH: Taxation of income from the transfer of VDAs at the rate of 30%;
- Section 56(2)(vii) & (x): Gift tax on VDAs - definition of 'property' expanded to include VDAs;
- Section 194S: Withholding tax (**"WHT"**) provision on payment of consideration for the transfer of VDAs to residents.

Our in-depth analysis of the above-mentioned provisions at the time of their proposal through the Finance Bill of 2022, can be found here. Since then, certain changes were brought about in the provisions of the Finance Bill, through FA 2022, and more recently, the Central Board of Direct Taxes (**"CBDT"**), and the Ministry of Finance (**"MoF"**) released a set of circulars and notifications to clarify the operability of the withholding provisions, the procedure for compliance, clarification on scope of VDAs etc.

In this hotline, we discuss and analyze the circulars/ notifications issued by CBDT.

A. Withholding on VDA Transactions Through Exchange [Circular No 13 of 2022] ("Circular 1")

Section 194S of the ITA obligates any 'person responsible for paying' to a resident any sum by way of consideration for transfer of a VDA to withhold tax at the rate of 1% at the time of payment or credit, to the account of the resident, whichever is earlier. Section 204 of the ITA defines the person responsible for paying to mean (i) in case of residents, the payer of the sum (or principal officer, in case of a company) and (ii) in case of non-residents, the person himself or any person authorized by the non-resident. In *Uber India Systems (P.) Ltd.*[101], the Income Tax Appellate Tribunal (**"ITAT"**) highlighted the distinction between payer and remitter and held that Uber India Systems Private Limited was not the payer, and consequently not the person responsible for paying.

Given the above, in case where an intermediary (like a cryptocurrency exchange) is facilitating transfer of VDAs on its platform, it was not clear whether such intermediary could be held liable to withhold tax under section 194S.[102] To remove such ambiguities, Circular 1 clarifies who would be liable to withhold tax under section 194S in case where VDA transactions take place through an Exchange[103] or Broker [104] (as defined therein).

101. Uber India Systems (P.) Ltd. vs. Joint Commissioner of Income Tax, [2021] 125 taxmann.com 185 (Mumbai - Trib.)

102. https://www.theweek.in/news/biz-tech/2022/02/07/why-crypto-players-are-confused-about-new-tax-rules.html

103. 'Exchange' means any person that operates an application or platform for transferring of VDAs, which matches buy and sell trades and executes the same on its application or platform. The definition is wide enough to cover both models of exchanges typically seen in the marketplace.

104. "Broker" means any person that operates an application or platform for transferring of VDAs and holds brokerage account/accounts with an Exchange for execution of such trades

3.Tax

The table below summarizes the clarification provided by Circular 1 with respect to the person responsible for withholding tax under section 194S.

S No	Consideration	Platform Model	Broker	Obligation to deduct tax
1.	Where consideration for the transfer is paid in fiat currencies	**Exchange Model** VDA (owned by another user/ Broker) transferred on the Exchange. The buyer and seller places orders on the Exchange platform. The Exchange matches and executes the order and earns in lieu of commission / service fee.	No broker involved	Tax to be deducted by the Exchange on the payment made to the seller (i.e. the owner of the VDA)
			Broker involved, where the broker holds title to the VDA (i.e. the broker is the seller)	Tax to be deducted by the Exchange on payment made to the Broker
			Broker involved, where the broker does not hold title to the VDA (i.e., the Broker is not the seller)	Obligation to deduct tax falls on both: a. the Exchange, and b. the Broker. However, Circular 1 provides that if there is a written agreement between the Exchange and the Broker that Broker shall be deducting tax, then Broker may deduct the tax under section 194S The Exchange will however need to furnish a quarterly statement for all such transactions in the quarter within the prescribed forms and due dates.
		OTC Model VDA (owned by Exchange) are transferred on the Exchange. The Exchange is the counterparty to such transactions and maintains its own repository of VDAs and conducts back-to-back transactions with the users.	No Broker involved	Primary obligation to deduct taxes is on the buyer or their Broker (as the case may be). However, Circular 1 provides an alternative wherein the Exchange may enter into a written agreement with the buyer or their Brokers stating that the Exchange would be paying taxes. The Exchanges would be required to furnish quarterly statements for all such transactions. It will also be required to furnish its income tax return and include such transactions therein. Circular 2 provides that if these conditions are complied with, the buyer or his Broker would not be held as assessee in default under section 201 of the ITA for these transactions.
			Broker involved, however, the Broker does not hold title to the VDA (i.e. the broker is not the seller)	

Circular 1 also clarifies that in case of transactions where consideration for transfer of VDA is paid in exchange of another VDA, the Exchange would be required to withhold tax on both legs of the transaction. The buyer and seller would not be independently required to follow the procedure provided in proviso to section 194S(1).

Circular 1 also clarifies that in case of transactions where consideration for transfer of VDA is paid in exchange of another VDA, the Exchange would be required to withhold tax on both legs of the transaction. The buyer and seller would not be independently required to follow the procedure provided in proviso to section 194S(1).

It is important to note that Circular 1 has been issued under section 194S(6) read with section 194S(7) of the ITA. Therefore, Circular 1 is binding on the tax authorities and the person responsible for paying.

It is important to note that Circular 1 has been issued under section 194S(6) read with section 194S(7) of the ITA. Therefore, Circular 1 is binding on the tax authorities and the person responsible for paying.

Our comments: The clarification provided by Circular 1 puts an end to confusion and extent of Exchange's liability to comply with section 194S. Circular 1 defines Exchanges for the first time with respect to the ITA. Given the different type of models, the definition of Exchange should provide clarity to market participants regarding obligation to withhold tax under section 194S. The compliance burden has been shifted from the users to the Exchange in most cases. Circular 1 also seems to have nailed several practical issues faced by the industry and provide feasible solutions. For example, it recognizes that there may be situations wherein tax deducted in kind may need to be converted into cash for depositing to the Government. In this regard, Circular 1 provides mechanism for tax deducted in kind into cash. The mechanism provided by Circular 1 is likely to increase the compliance burden on the Exchanges (with the Exchanges required to maintain trail of transactions, time stamping of order etc.). Further, the mechanism for accumulation of tax deducted in form of primary VDAs till end of the day and conversion into cash at midnight may provide opportunities to participants to engage in price play. This will need to be carefully monitored by Exchanges as well. In a welcome move, Circular 1 has also clarified that there will be no further withholding on conversion of tax withheld in kind into INR.

B. Withholding on Transactions Not Covered Under Circular 1 [Circular No 14 of 2022] ("Circular 2")

Circular 2 (except question 6) is applicable on all transactions not covered by Circular 1 i.e. transactions in relation to transfer of VDA not on or through an Exchange. Circular 2 *inter-alia* clarifies the liability to withhold tax in the following situations:

- When the consideration is paid in fiat: In peer to peer transaction (i.e. buyer to seller without going through an Exchange), the buyer (i.e. person paying the consideration) is required to deduct tax under section 194S of the ITA. The tax base for withholding is consideration for transfer of VDA as reduced by goods and service tax (**"GST"**).

- When the consideration is paid in kind: In such a case, the person responsible for paying such consideration is required to ensure that tax required to be deducted has been paid in respect of such consideration, before releasing the consideration. Thus, the buyer will release the consideration in kind after seller provides proof of payment of such tax (e.g. challan details etc.).

- When consideration is paid in exchange of another VDA: In such a case, both the buyer and seller need to pay tax with respect to the individual transfer of VDAs. Once tax is pay, both the buyer and seller are required to show evidence to the other person so that the VDAs can be exchanged.

Without going into the merits of whether VDA is a good or not, Circular 2 also clarifies that once tax is deducted under section 194S, tax would not be required to be deducted under section 194 Q (withholding on purchase of goods).

Our comments: At the outset, it is important to note that unlike the guidelines issued Circular 1, Circular 2 has been issued under section 119 of the ITA. Therefore, while Circular 1 is binding on the tax authorities and the person responsible for paying, it may be possible to argue that Circular 2 is binding only on the tax authorities, and not on the taxpayers. [105]Having said this, it is not clear why Circular 2 was also not issued under section 194S(6).

As discussed above, Circular 2 is applicable only on transactions not falling in the ambit of Circular 1. Therefore, in cases where VDA transactions are not happening through an Exchange, withholding under section 194S

105. See Navnit Lal C. Javeri vs. K.K. Sen, Appellate Assistant Commissioner of Income-tax, [1965] 56 ITR 198 (SC), Catholic Syrian Bank Ltd. vs. Commissioner of Income-tax [2012] 343 ITR 270 (SC) etc.

should be done in accordance with Circular 2. Further, while Circular 2 clarifies that tax base for withholding will be reduced by GST, applicability of GST on VDAs is not clear. There have been news reports suggesting that Indian government is working on characterization of crypto-assets for the purpose of GST laws.[106]

C. Other Clarificatory Updates

The CBDT also issued 2 other notifications, shedding further colour to the tax regime of VDA:

a. **Exclusions from the definition of VDA** [CBDT Notification dated June 30, 2022] (**"Notification 3"**): Owing to the significantly wide definition of VDAs introduced through FA 2022, there was a lack of clarity as to whether airline reward points, credit card points, gift cards, etc. would also fall within the definition of VDAs. The Notification 3 excludes the following VDAs from the definition of VDAs:

- Gift cards 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, loyalty cards, being a record (i) given without direct monetary consideration under an award, reward, benefit, loyalty, incentive, rebate or promotional program (ii) that may be used or redeemed only to obtain goods or services or a discount on goods or services;
- Subscriptions to websites or platforms or applications.

Our comments: While the exclusions notified by the CBDT are welcome, it is important to note that the CBDT has worded the aforesaid notification in a narrow manner. The Notification 3 makes it clear that the items excluded earlier fell under the definition of VDAs. Having said this, it is important that emphasis is given to the exact language of the notification to determine whether the exclusion is applicable in case of a particular VDA or not. For example, in case where reward points are issued to users two conditions have to be satisfied for being excluded from the definition of VDAs – (i) the reward points should be given to the user without any direct monetary consideration under an award / reward program, and (ii) the reward point may be redeemed only to obtain goods or services or discount on goods or services. Therefore, in case where reward points can be used to obtain other cryptocurrencies or native / non-native tokens, it may not fall under the ambit of the exclusion depending on whether such cryptocurrencies or native / non-native tokens can be said to be 'goods' or 'services'. Similar issues may arise in case where reward points may be redeemed to obtain a voucher. Pertinent to note that both Circular 1 and Circular 2 do not clarify whether VDAs will be characterized as goods for tax purposes or not. Same condition will have to be checked for gift cards or vouchers to qualify for the exclusion. Further, it is unclear why 'subscriptions to websites or platforms or applications' were required to be excluded from the definition of VDAs.

b. **Clarification with respect to the scope of Non-Fungible Tokens ("NFT")** [CBDT Notification dated June 30, 2022] (**"Notification 4"**):

NFTs are specifically included within the scope of VDA as a separate category. Notification 4 specifies that a token which qualifies as a VDA is an NFT within the ITA. However, an 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 is excluded from the scope of NFT.

Our comments: The clarification provided under Notification 4 is welcome. NFTs generally represent a unique and existing physical or virtual goods, service or asset (e.g. artwork, music, real estate property etc.). It was not clear whether the tax department may view sale of an NFT as combination of two transactions – (1) sale of NFT itself,

106. Available at: https://economictimes.indiatimes.com/news/economy/policy/govt-working-on-classification-of-cryptocurrency-under-gst-law/articleshow/90333798.cms (last accessed on June 08, 2022).

and (2) sale of the underlying property / asset represented by NFT. The clarification under Notification 4 should exclude cases where physical assets like land, painting etc. are tokenized and transferred through NFTs. Such NFT through which land or part of land is transferred and the ownership in the underlying land is also transferred will be excluded from the scope of VDAs. The sale of land will be taxable as per the usual provisions of the ITA and the VDA regime should not be applicable. This may give a boost to tokenization of physical assets. It is important to note that the Notification 4 covers only NFTs whose transfer results in transfer of ownership of underlying tangible (physical) assets. While practically ownership in underlying intangible assets (like music, video clip etc.) may not be transferred through NFTs, it will be important to closely examine the tax implications of such transactions as well.

D. Conclusion

The aforesaid clarifications, though last minute, have been welcomed by the industry participants. Several crypt-exchanges have implemented procedures to give effect and operationalize withholding from July 1, 2022. While the clarifications are technically applicable on foreign exchanges as well, foreign exchanges are likely to face more challenges in operationalizing withholding mechanism.

Having said this, the tax regime for VDAs is likely to evolve further in future. There are a number of open issues which continue to remain present. Currently, there are no guidelines on valuation of VDAs. This will be essential for determining tax base from income-tax and GST perspective. Valuation of VDAs may be particularly challenging given the volatility of the crypto-market. Lastly, the decision with respect to applicability of GST on VDAs may define the course of this industry in India.

– **Arijit Ghosh & Ipsita Agarwalla**

April 26, 2021

V. Taxing Non-Fungible Tokens

Non-fungible tokens (**"NFTs"**) are digital tokens that operate on a public blockchain and can be used to represent ownership of a unique item, whether digital or physical. Each NFT is unique and unlike other fungible assets or currencies, they cannot be exchanged with one another. NFT products can be representative of a variety of elements and can tokenise things like art, collectibles and fashion items to collectible sports cards, virtual real estate and characters. Globally recognized brands like Nike, Louis Vuitton, as well as the NBA have begun generating NFT-based consumer goods and services.[107] IBM has recently announced that it will turn corporate patents into NFT so that the patents can be easily sold, traded or otherwise monetized.[108] NFTs have the potential to create a paradigm shift by creating an 'Internet of Assets'.

NFTs can either be created by developers or by users through third-party marketplaces. NFT marketplaces such as OpenSea, Rarible or Nifty Gateway facilitate the online sale of items through the use of NFTs to represent title or ownership. A typical NFT marketplace transaction begins with the seller "minting" an NFT to represent ownership of the unique item that they wish to sell. The seller then lists the item on the marketplace. Both stages require payment of a "gas fee", which users are responsible for paying towards the computing energy required to validate transactions on the blockchain. The gas fees fluctuate depending on the time of day and is sent directly to miners who run the blockchain network.

Once the item is listed on the marketplace, a buyer may either purchase it directly or place a bid in an auction. The buyer pays the consideration amount, the gas fees, and the commission charged by the marketplace. The entire transaction usually takes place through the operation of a smart contract where payments are automated and made directly between parties instead of through the intermediary NFT marketplace. As a result, the marketplace does not have access to any amount paid by the buyer except for its sales commission. More than $2 billion was spent on NFTs in the first quarter of 2021 – representing an increase of about 2100% from last quarter of 2020.[109] Given this recent surge, we have summarized the potential tax implications of such transactions in this hotline.

While the tax treatment of NFTs should generally depend on the nature of the underlying asset, there may be other issues in case of cross-border NFT transactions.

A. Equalization Levy

The Finance Act, 2020 expanded the scope of the equalization levy ("EL") to be applicable on e-commerce operators at rate of 2 percent on the consideration received or receivable by such e-commerce operators from 'e-commerce supply or services' made or provided or facilitated by it to specified persons. Accordingly, the NFT marketplaces may be subject to EL at rate of 2% if it receives consideration from 'e-commerce supply or services' made to a person resident in India, a person using an Indian internet protocol (**"IP"**) address, or a non-resident in certain specified circumstances. The term 'e-commerce supply or services' has been defined very broadly such that it is not necessary that the entire transaction takes place online. The e-commerce operator would be subject to EL even if one of the aspects of the transaction, such as acceptance of offer of sale or placing of purchase order or payment of consideration, etc. takes place online. In relation to the tax base, the Finance Act, 2021 has clarified

107. Kay, Grace. (2021, March 3). What you need to know about NFTs, the collectible digital tokens that are selling for millions online. *Business Insider*. https://www.businessinsider.in/tech/news/what-you-need-to-know-about-nfts-the-collectible-digital-tokens-thatare- selling-for-up-to-millions-online/articleshow/81199814.cms

108. Chipolina, Scott. (2021, April 21). IBM Is Turning Patents Into NFTs. Decrypt. https://decryptco.cdn.ampproject.org/c/s/decrypt.co/68501/ibm-is-turning-patents-into-nfts?amp=1

109. Burch, Sean. (2021, April 3). NFT Market Surges 2,100% to $2 Billion in Q1 Sales. *The Wrap*. https://www.thewrap.com/nft-marketsurges- 2100-to-2-billion-in-q1sales/#:~:text=More%20than%20%242%20billion%20was,a%20new%20report%20NonFungible.com.

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that the EL would apply on the entire consideration received from the buyer, and not just the commission amount retained by the e-commerce operator.

Applying this provision to the purchase of NFTs would lead to certain complications.

Firstly, the definition of ecommerce operator under the EL provision is very wide and may extend to any electronic service which may facilitate a buyer and a seller to carry out an NFT transaction, including the blockchain operators and not just the NFT marketplace.

Secondly, at no point during the transaction does the NFT marketplace have access to the sale consideration of the NFT. This non-custodial feature results in a situation of impossibility where the marketplace would have to pay 2% of the entire consideration, even when it does not have access to the consideration amount.

Thirdly, it is unclear whether the gas fees, which goes neither to the seller nor the e-commerce operator but directly to blockchain miners, would be considered to be part of the tax base for levy of EL in the hands of the NFT marketplace. Fourthly, it may be impractical or unfeasible for the e-commerce operator to keep track of the IP address or the location or residency of each buyer or seller for determining applicability of EL.

B. Withholding Tax

Section 194-O of the Income-tax Act, 1961 (**"ITA"**) imposes withholding tax obligations on e-commerce operator from April 1, 2020. Section 194-O provides that the e-commerce operator would be liable to withhold tax at the time of credit of consideration to the resident seller, at the rate of 1% of the gross amount of sale. Further, in case the sale is facilitated by the e-commerce operator, but payment is made by the buyer directly to the resident seller, section 194-O deems the e-commerce operator to have paid the resident seller such money and therefore be obligated to withhold income-tax at 1% on such sums as well. Section 194-O does not make a distinction between a resident and a non-resident e-commerce operator.

Therefore, basis a strict reading, the withholding obligations under section 194-O may also apply to a non-resident e-commerce operator facilitating sale of goods or provision of service of a resident seller, hence, increasing the compliance burden for non-resident e-commerce operators. Therefore, it may be possible that even though the non-custodial NFT marketplace does not credit the amount to the seller, it would be liable to deduct tax on the consideration paid directly to the seller through the smart contract. The application of this section would create cashflow problems for an NFT marketplace or similar facilitation platforms as they would have to withhold tax on gross consideration (including sales commission) irrespective of whether the consideration flows through them or not.

C. Tax Collection At Source

The buyer and the seller also need to discharge tax liability at the time of sale of goods. Section 206C imposes an obligation on a seller to collect tax at source (**"TCS"**) at rate of 0.1% of the sale consideration received on sale of goods in excess of INR 50 lacs as income-tax.[110] Please note that this tax is required to be collected by the seller from the buyer only if the total sales, gross receipts or turnover of the business carried on by the seller is more than INR 10 crores during the financial year immediately preceding the financial year in which the sale of goods is carried out.

Further, the TCS is deemed to be payment of tax on behalf of the buyer and the buyer is given the credit of such TCS.

110. Section 206C(1H) of the ITA; the provision comes into effect from October 1, 2020

Under the recently introduced section 194Q,[111] the buyer has a liability to deduct tax at source at a rate of 0.1% on the consideration paid for a sale or aggregate of sales exceeding INR 50 lacs, provided the buyer had a gross turnover exceeding INR 10 crores in the previous year. The interplay of section 206C and section 194Q is such that while section 206C releases the seller from the TCS liability if the buyer is required to withhold tax under any provision of the ITA, section 194Q to the contrary provides that the withholding obligation will be applicable on the buyer irrespective of seller's TCS liability.

Whereas in a physical sale of goods, a buyer and a seller could communicate to each other to figure out which provision would be applicable, such communication is limited when the sale of goods is taking place through an NFT transaction. Another concern for buyers is that when a sale of physical goods takes place through an NFT, either the seller or the marketplace would have to take responsibility for the delivery of the goods. This responsibility may not be currently accounted for in the terms of service of various marketplaces, as the focus is primarily on online sale of digital goods which could take place in a non-custodial manner through the operation of smart contracts.

D. Goods and Service Tax

Under the Goods and Services Tax (**"GST"**) regime, an NFT marketplace may be considered an intermediary. NFT marketplaces should ensure that they clearly demarcate the various fees and consideration amounts that are to be paid by the buyer, so that their liability for intermediary services is limited only to the extent of their sales commission.

Further, classification of the supplies for GST purposes would again depend on the nature of the underlying transaction. GST applicability would also depend on whether the NFT platform is located in India or outside. The GST regime also obligates electronic commerce operator to collect tax at source at a specified rate of the net value taxable supplies made through it by other suppliers where the consideration with respect to such supplies is to be collected by the operator.[112] In this regard, while the TCS obligation under GST may apply on normal marketplace wherein the consideration for supply is collected by the marketplace, in case of an NFT marketplace, the TCS obligation under GST should not apply as the consideration for supply is not collected by the NFT marketplace and is instead directly paid between parties through an automated contract.

While, the regulatory framework for blockchain and crypto-asset ecosystem is in limbo in India, it is essential that parties undertaking NFT transactions should correctly assess and comply with the tax obligations as applicable. Failure to do so may entail consequence for buyers, sellers or the marketplace as well.

– **Ipsita Agarwalla & Meyyappan Nagappan**

111. With effect from July 1, 2021
112. Section 52 of the CGST Act, 2017

July 7, 2021

VI. Technology & Tax Series – Issue X

A. Background

The significant majority of countries constituting the 131 member Inclusive Framework (**"IF"**) on Base Erosion and Profit Shifting (**"BEPS"**) have agreed on the broad construct for a deal for Pillar One and Pillar Two proposals (**"Agreement"**).[113] The key features of the Agreement with respect to Pillar One are set out below, which are more favourable to developing countries when compared with the G7 announcement or the US IF proposal (defined below).

However, several crucial features of the US and G7 proposals also seem to have been accepted such as applying the proposal to all companies and not just digital companies. Before we analyse the impact of these proposals, we set out first how we got here.

i. Genesis

The tax challenges of the digitalisation of the economy were identified as one of the main areas of focus of the OECD / G20 BEPS Project, leading to the 2015 BEPS Action 1 Report (**"Action 1 Report"**).[114] The Action 1 Report found that the whole economy was digitalising and, as a result, it would be difficult, if not impossible, to ring-fence the digital economy.

Continuing the work of Action 1 Report, the G20 formed a Task Force for Digitalized Economy (**"TFDE"**) which delivered an Interim Report in 2018 identifying three characteristics of digitized businesses: (i) scales without mass, (ii) heavy reliance on intangible assets, and (iii) data and user participation, as being the main challenges to the existing legal framework.[115] This was followed by the OECD / G20 Inclusive Framework on BEPS agreeing on a Programme of Work[116] for addressing the tax challenges of the digitalisation of the economy and arriving on a consensus-based solution by 2020.

The Programme of Work is divided into two pillars:

Pillar One addresses the allocation of taxing rights between jurisdictions and considers various proposals for new profit allocation and nexus rules;

Pillar Two focuses on the remaining BEPS issues and seeks to develop rules that would provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.

113. OECD (2021), OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors – July 2021, OECD, Paris, www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-july-2021.pdf.

114. OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241046-en

115. OECD (2018), Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264293083-en

116. OECD (2019), Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, www.oecd.org/tax/beps/programme-of-work-to-develop-aconsensussolution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm.

3.Tax

The OECD / G20 Inclusive Framework on BEPs had released a package consisting of the Reports on the Blueprints of Pillar One[117] and Pillar Two[118] (**"Blueprints"**), which reflected convergent views on key policy features, principles and parameters of both Pillars, and identified remaining political and technical issues where differences of views remain to be bridged. While the cover statement of the Blueprints provided that participants have agreed to swiftly address the remaining issues with a view to bringing the process to a successful conclusion by mid-2021, the pandemic had stalled the discussions at the global level. In addition to the Blueprints, the OECD also released an economic analysis and impact assessment report (**"Impact Assessment Report"**) which analyses the economic and tax revenue implications of the Pillar One and Pillar Two proposals.[119]

Simultaneously, the UN Committee of Experts on International Cooperation in Tax Matters (**"UN Committee"**) released alternative proposal for introduction of a new Article 12B to tax income from Automated Digital Services (**"ADS"**)[120] in the United Nations Model Tax Convention (**"UNMC"**) for the taxation of digital economy.

Meanwhile, in the absence of global consensus, countries resorted to adopt independent unilateral measures through digital services tax (**"DST"**), and equalization levy's (**"EL"**) to tax digital businesses participating in their economies which do not meet the current physical nexus requirements. In response to these unilateral measures, the Office of the United States Trade Representative (**"USTR"**) initiated investigations under Section 301[121] of the Trade Act of 1974 (**"Section 301 Investigation"**), against DST's imposed by 9 countries, including India. The Section 301 Investigation involved determination of whether the act, policy, or practice i.e., India's DST – is actionable under Section 301 of the Trade Act of 1974 (**"Trade Act"**), and if so, what action, if any, to take under Section 301. On January 6, 2021, USTR released the Section 301 Investigation Report on India's Digital Services Tax (**"USTR Report"**), concluding that the EL on-e-commerce operators is 'actionable' under the Trade Act. Importantly, the USTR Report stated that the United States remains actively engaged in the OECD Inclusive Framework process and supports bringing the negotiations to a successful conclusion.

The USTR Report stated that unilateral laws like India's DST undermine progress in the OECD by making an agreement on a multilateral approach to digital taxation less likely. Pursuant to the finding in the USTR Report, the USTR proposed to impose retaliatory additional tariffs of up to 25% ad valorem on an aggregate level of trade for certain specific products.[122] The aim of such retaliatory tariff was to neutralize the impact which India's EL is expected to have on U.S. companies.

Recently, the U.S. Department of the Treasury USA announced the Made in America Tax Plan (**"Tax Plan"**) with the objective to make American companies and workers more competitive by eliminating incentives to offshore investment, substantially reducing profit shifting and countering tax competition on corporate rates.[123] In addition to the Tax Plan proposals, the presentation by the US to the Steering Group of the Inclusive Framework meeting was leaked (**"US IF proposals"**).[124]

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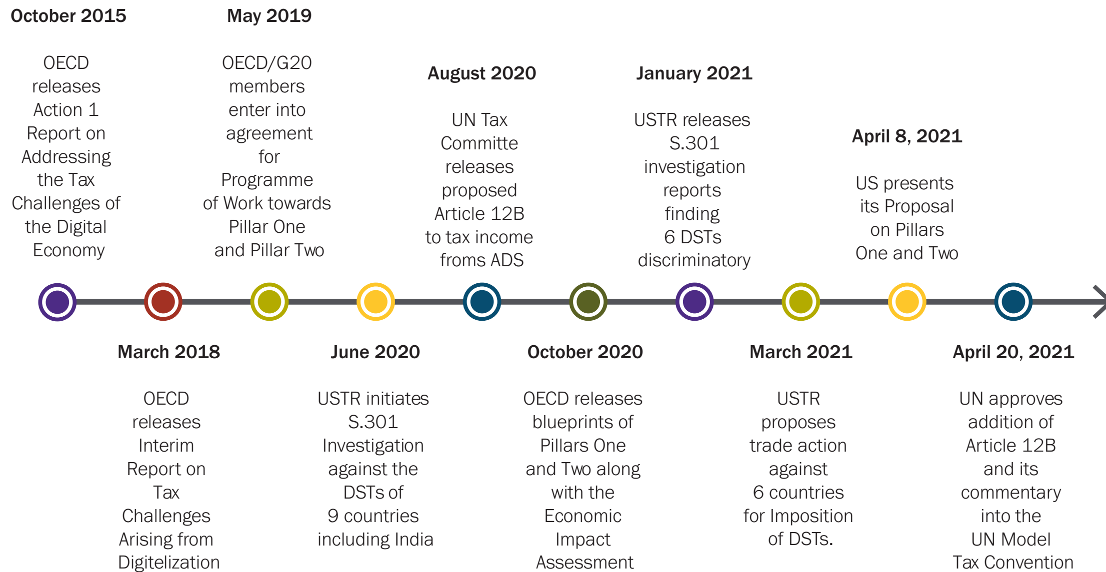
117. OECD (2020), Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/beba0634-en.
118. OECD (2020), Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/beba0634-en.
119. OECD (2020), Tax Challenges Arising from Digitalisation – Economic Impact Assessment: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/0e3cc2d4-en.
120. UN Committee of Experts on International Tax Cooperation in Tax Matters (2020), 20th Session, Tax Consequences of the Digitalised Economy-issues of relevance for Developing Countries, Co-Coordinator's Report, E/C.18/202/CRP.41
121. Section 301 of the Trade Act sets out three types of acts, policies, or practices of a foreign country that are actionable: (i) trade agreement violations; (ii) acts, policies or practices that are unjustifiable (defined as those that are inconsistent with U.S. international legal rights) and burden or restrict U.S. Commerce; and *(iii) acts, policies or practices that are unreasonable or discriminatory and burden or restrict U.S. Commerce.*
122. Proposed Action in Section 301 Investigation of India's Digital Services Tax, March 31, 2021
123. Made in America Tax Plan Report. Available at: https://home.treasury.gov/news/featured-stories/made-in-america-tax-plan-report
124. Martin, Julia. (2021, April 12). Leaked copy of US proposal for Pillar One and Two multinational group tax reforms available. MNE Tax. https://mnetax.com/wp-content/uploads/2021/04/US-slides-for-Inclusive-Framework-meeting-of-4-8-21-2.pdf

The announcement of the Tax Plan and the US IF proposals re-ignited the global discussions on digital taxation and brought back hope regarding countries arriving at a consensus-based solution for digital taxation. A snapshot of the timeline on international development on digital taxation is provided below:

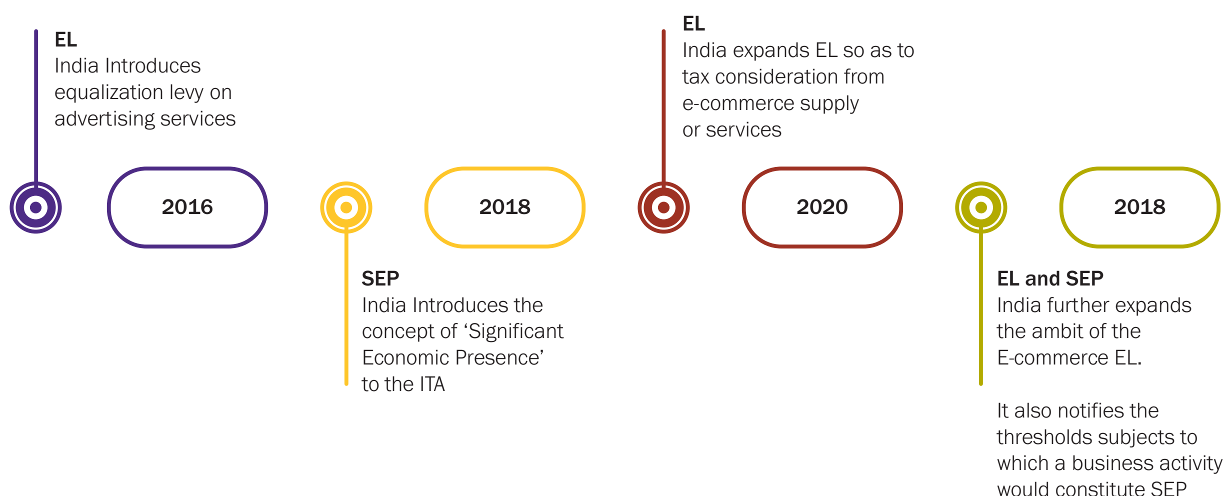


ii. Digital Taxation in India

India has incorporated several OECD recommendations arising from the BEPS project under the ITA, being an active member of G20 and a Key Partner of the OECD. While several proposals on digital taxation were being discussed internationally, India took an opposing approach by expanding the scope of EL by the Finance Act, 2020 to apply EL at rate of 2% on consideration received or receivable by non-resident e-commerce operators for e-commerce supply or services to specified persons (**"E-commerce EL"**). The Finance Act, 2021 amended the E-commerce EL provisions and further expanded the scope of the E-commerce EL. Notably, the E-commerce EL applies on transactions between nonresidents targeting Indian customers as well. Further, given that the ITA specifically exempts income subject to Ecommerce EL from income-tax and that the collection and recovery mechanism of E-commerce EL rely on the provisions of ITA, theoretical arguments exist that E-commerce EL may be considered as 'taxes covered' under Article 2 of the tax treaties and hence, treaty benefits may be obtained. However, this position remains untested in India. In the event Ecommerce EL is not covered under the tax treaties, there exists a risk of double taxation.

In 2018, India introduced the concept of "significant economic presence" (**"SEP"**) under the Income Tax Act, 1961 (**"ITA"**)[125], in order to bring under its ambit the income derived by non-resident businesses, through certain activities in India, who were otherwise without a taxable presence. Since then the SEP provisions have not been operative in absence of the thresholds of the specified activities. Recently, India also announced the SEP thresholds and accordingly, the SEP provisions are now applicable from April 1, 2021.
A snapshot of the timeline on development on digital taxation in India is provided below:

125. Explanation 2A to Section 9(1)(i).



B. Summary of The Agreement

i. Pillar One Proposal

Scope: Multinational enterprises (**"MNEs"**) with global revenue more than 20 billion euros and profitability rate greater than 10% would be considered in-scope. The global revenue threshold would be reduced to 10 billion euros going forward. Extractive and financial service sector have been carved out from the scope of Pillar One. The previous notion of covering only automated digital services (**"ADS"**) and consumer facing businesses (**"CFB"**) has been done away with.

Nexus: Nexus will be established by the revenue derived by an in-scope MNE from a jurisdiction. In general, 1 million euros revenue from a jurisdiction has been agreed threshold for establishing nexus, for smaller jurisdictions (GDP below 40 billion euros) the revenue threshold has been reduced to 250,000 euros.

Quantum: 20-30% of the profits exceeding 10% margin threshold will be available for redistribution within market jurisdictions. The G7 Agreement in June, 2021 specified rate of at least 20% for residual profits, hence the current Agreement reflects the intent of increasing distributions in favour of market jurisdictions.

Revenue Sourcing: Revenue will be sourced to the end market jurisdiction i.e. where goods or services are used or consumed. However, the exact rules to determine where the usage or consumption has occurred are yet to be determined. MNEs will also be given liberty to choose a reliable method based on their specific facts and circumstances. This is different from the October 2020 blueprint which provided a hierarchy of rules for each revenue stream to be followed by all in-scope companies.

Segmentation: The Agreement provides that segmentation will be undertaken only in exceptional circumstances to include segments of MNEs qualifying under the scope rules basis disclosure in financial statements. This will be relevant for situations wherein the MNE group as a whole does not (primarily due to profit margins) qualify under the scope rules.

Tax Base: This will be determined on basis of financial accounting income (with few adjustments) and provision for carry forward of losses will also be present.

Marketing and Distribution Profits Safe Harbour: In case profits of an MNE are already taxed in a market jurisdiction, then the Amount A liability will be capped to that extent. However, design of the safe harbour is yet to be finalised.

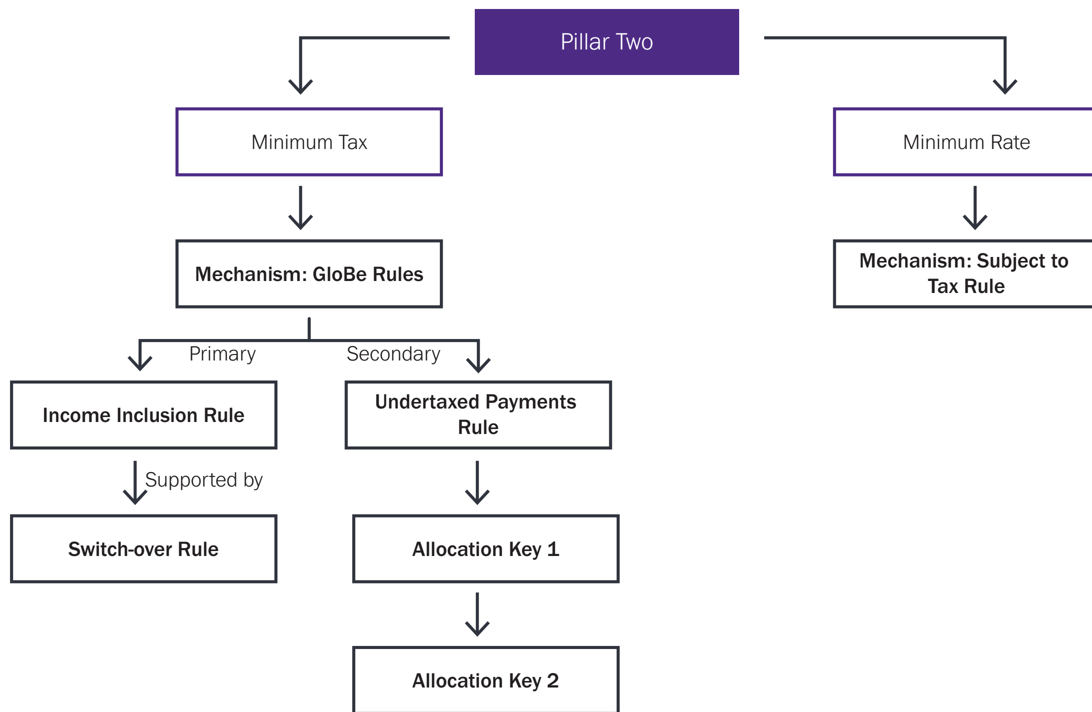
Tax Certainty: Disputes relating to all issues concerning Amount A will be resolved in a mandatory and binding manner. An elective mechanism will be provided to developing countries based on certain agreed criteria.

Administration: All compliances are proposed to be completed through one entity

Unilateral Measures: Digital Service Taxes and other relevant similar measures, such as the Equalisation levy, would be phased out with the application of new rules.

Implementation: The Pillar One proposal would be implemented through a multilateral instrument and the Amount A will come into effect in 2023.

ii. Pillar Two Proposal



A quick recap of the different rules under Pillar Two is set out above.

It is not mandatory for the IF members to apply Global anti-Base Erosion (**"GloBE"**) rules i.e. income inclusion rule (**"IIR"**) and undertaxed payment rule (**"UTPR"**). However, if an IF member applies GloBE rules it would need to be consistent with model rules and guidance, and it should also accept GloBE rules applied by other members including the *rule order* and application of any agreed safe harbours.

MNEs with revenue over 750 million euros would be covered within scope of Pillar Two. However, a jurisdiction in which an MNE is headquartered may apply the IIR even if revenue threshold is not met.

GloBE rules will be applicable on a jurisdictional basis and tax base will be determined according to financial accounting income (with agreed adjustments). Top up taxes will not be imposed if the earnings are distributed within 3-4 years and are taxed at or above the minimum rates.

The minimum rate for the purpose of GloBE rule will be at *least* 15%.

A formulaic substance based carve out will exclude amount of income that is at least 5% of the carrying value of tangible assets and payroll. There will also be a de minimis threshold for applicability of GloBE rules.

Consideration will be given to the conditions under which US global intangible low-taxed income (**"GILTI"**) regime will exist with GloBE rules.

Subject to tax rule (**"STTR"**) will provide a taxing right on the difference of minimum rate and tax rate of payment relating to interest, royalties and a defined set of other payments. Minimum rate for the purpose of STTR will be from 7.5% to 9%.

- Implementation plan would include:
- GloBE model rules to be developed for facilitating the rules that have been implemented by IF members, including a possibility for introducing a multilateral instrument.
- STTR would be implemented through amendments in bilateral treaties. A model STTR provision along with
- multilateral instrument will be introduced.
- There will be some transitional rules, which will include possibility of a deferred implementation of the UTPR.
- The implementation plan for Pillar Two will be brought into law in 2022 and will be effective from 2023. Possibility for exclusion of MNEs which are in initial phase of international activity, from scope of Pillar Two will also be explored.

The Agreement reflects consensus on broad framework on the two Pillars. The implementation plan and open issues are to be finalised by October, 2021. A G20 Finance Ministers meet is also scheduled on July 9 – 10, 2021, where we could witness some more developments.

C. Advantages of The Agreement

The success of Pillar One proposal hinges on international consensus and the amount of tax revenue ultimately being allocated to market jurisdictions like India. It is clear that the original Pillar One proposals were complex, both for the tax administration and multinational companies, and the implications under Pillar One would differ with different business models.

While the Trump administration favoured a safe harbour approach for Pillar One and pushed for grandfathering for Pillar Two, the Biden administration has decided to re-engage with OECD with a view to reaching a global solution. The engagement of the United States has been a major factor leading to the Agreement. However certain recent actions by India, such as imposing SEP or expanding the EL, seemed to be increasing the divide instead of bridging the gap, thereby, threatening the fragile hope for a consensus-based solution.

Nevertheless, recent statements by Indian Government show support for the Pillar One and Pillar Two proposals perhaps indicate a willingness to make the deal work.

The complexity associated with the Pillar One proposals was identified by the OECD as one of the key technical issue for Pillar One. Therefore, to this extent, the Agreement supports simplification through a neutral scope definition based on objective factors without regard to business model being digital or otherwise. With increasing digitalization of all business models, this is more likely to create a stable international tax framework which can

survive for the long term even as business models undergo greater digital change. This is also in line with the principles agreed in the Ottawa Electronic Commerce: Taxation Framework being, neutrality, efficiency, certainty and simplicity. The Agreement seems to resonate this and focuses towards a sector neutral tax policy.

The next issue is with respect to administrability of Pillar One. In order for developing countries to actually benefit from Pillar One proposal, the revenue allocation should outweigh the administrative costs. The Pillar One Blueprint prescribed threshold of EUR 750 million (which would be reduced in a phased manner in future) for application of Amount A. The Pillar One Blueprint provides that approximately 2,300 MNEs with primary activity in ADS or CFB would be in-scope after application of the global revenue threshold of EUR 750 million.

Also, economic impact studies show that using a smaller number will not dramatically increase the amount of revenues from the Amount A taxing right[126]. In this regard, the Agreement has suggested a threshold of EUR 20 Billion, that targets only the 'largest and most profitable MNE groups', regardless of industry classification / business model, within the scope of Pillar One.

The Agreement clarifies that segmentation will occur only in exceptional circumstances which would also result in a neutral, simpler, proposal that would also entail lesser compliance costs for taxpayers.

The Agreement provides that Pillar One would be operational through a multilateral instrument which will be developed an opened for signature in 2022. Although many countries have committed to reaching a solution, certain newly introduced features, such as mandatory dispute resolution, might affect the support from some developing countries, which have voiced concerns against such non-optional mechanisms in the past. Any feature that may seem like an infringement of a country's sovereignty would make the political negotiations surrounding Pillar One contentious. The Agreement has however sweetened the deal by proposing that if Pillar One is successfully implemented then the threshold for Pillar One applicability would come down to EUR 10 Billion after 7 years.

i. Is the Agreement beneficial for developing countries?

At the outset, the Agreement is a high level document and it may be too early to conclude that the Agreement would be harmful to developing countries like India. While concerns have been raised regarding whether the Agreement may result in a reduction of taxes towards developing countries, it appears such fears are based on assumptions at this point given the fine print may not be available for those proposals. Open points such as profit allocation ratios and negotiations around nexus thresholds would have a significant impact on the final tax position of developing countries under Pillar One. Thereby, the trade-off between a reduced pool available for distribution compared to other benefits from a simplified proposal should be assessed while arriving at a decision.

There are obvious benefits to reducing the total number of companies that are covered from an administrability and simplification perspective as stated above. Further, the Agreement to cover all profitable companies irrespective of the level of digitalization in their current business models would also be aligned with tax policy principles with respect to neutrality. This effect is achieved while also ensuring that the profitable tech companies fall within its coverage. Therefore, any negative assessment of the proposal at this stage based on publicly available information may be premature and based on assumptions. The focus should indeed be on the long term and not be focused on taxing companies that are perceived to have escaped taxation in the last decade.

126. https://oxfordtax.sbs.ox.ac.uk/article/who-will-pay-amount-a?dm_i=17AR,7FZYU,ELTIXA,U90CK,1

ii. Future of EL provisions

The Agreement provides that implementation of Pillar One proposals must include a commitment from members of IF to withdraw Digital Service Taxes and not adopt such measures in the future. However, it is unclear whether removal of unilateral measures i.e. E-commerce EL would be possible from the Indian perspective.

This may be because the (i) Pillar One Blueprint reaffirms the current international political position of the Inclusive Framework, which has not reached consensus on key design and threshold issues; (ii) It suggests to implement a mandatory dispute resolution framework which goes against Indian tax policy, and is unlikely to be accepted; (iii) As per the Impact Assessment Report, the specific impact of the OECD Proposal on revenue gains within the Indian economy remains unclear.[127] As per media reports, the EL alone has generated more revenue in the last year (~USD 124 million in FY 2018-19)[128], than is presumed to come in through the new Pillar One framework. However, with the Agreement stating the upto 30% of residual profits may be allocated to market countries, it is inching closer to India's demands. However, India has also made it clear that the intent is to collect more taxes through Pillar One compared to EL, in which case not only 30% of profits must be allocated but also that the 30% is to be calculated based on the total profits and not just residual profits over a 10% profit margin.

Therefore, it may be reasonable to assume that the EL will remain intact for the near future.

iii. Why UN proposal does not work

At the outset it must be noted that the proposed changes by the UN Committee are amendments to the existing bilateral treaty framework, and do not suggest a multilateral instrument to resolve issues involving more than two jurisdictions. This implies that the UNMC would be incapable of covering multijurisdictional situations of profit allocation of the global revenue of multinational enterprises across multiple market jurisdictions. For example, the UN proposals does not allocate / recognize value created through exchange of date on multisided business platforms.[129] To the contrary, Pillar One recognizes and taxes this as a value creating function. From a technical perspective, it does not cover all the transactions that the EL currently covers and as a practical matter implementing it is not a short or medium or long term solution.

The UN Committee comprised 25 members from various states, all working in their personal capacity. Among the members who were on the drafting committee, a significant minority dissented on various aspects of the Article. Compared to this, representatives from 139 countries are working on the OECD Pillar One and Two. The OECD also has greater technical capacity due to the number of personnel working with the Inclusive Framework. It is unlikely that these countries, which are committed to a multilateral framework, would instead go through tedious bilateral negotiations with various states, to implement an article which does not guarantee the removal of unilateral taxes such as the EL.

127. The global revenue growth estimated from Pilar One and Pillar Two both, is approximately 50-80 billion USD (4% of global corporate income tax revenue). However, the tax revenue gain experienced by most economies from the Pillar One reallocation will be a relatively small portion of the overall predicted gain, with 'investment hubs' experiencing a substantial loss in tax revenues. Majority of the tax revenue gains of the estimated over all 4% increase would thus be from Pillar Two, which proposes a minimum tax rate (giving countries the right to tax back profit of the global multinational enterprise that is taxed below the minimum rate elsewhere). Revenues from the proposed minimum tax under Pillar Two is disproportionately higher in high income economies, as opposed to a minimal increase in low/middle income countries. Pillar Two will also lead to increased revenue gains from reduced profit shifting, the impact of which is largely similar for most economies. [OECD 2020, Web-cast Presentation, Tax Challenges Arising from the Digitalization of the Economy- Update on the Economic Analysis and Impact Assessment, 13.02.20] http://www.oecd.org/tax/beps/presentation-economic-analysis-impact-assessment-webcast-february-2020.pdf

128. https://www.businesstoday.in/current/economy-politics/tax-on-online-ads-on-google-facebook-makes-govt-richer-by-rs-939-crore/story/378130.html

129. For example, multi-sided markets such as Google and Facebook. In these models, one side of the market exchange is between the entity and the user, which is for a free service (social media, search engine) in exchange for user data collected through the process. This data is then processed and exchanged for monetary consideration to the other side of the market as targeted advertisement for businesses, thus generating monetary value creation.

iv. Is global agreement on minimum tax possible?

As mentioned above, Pillar Two proposal was the OECD's plan to plug remaining BEPS issues and develop rules to provide jurisdictions the right to "tax back" where other jurisdictions have not exercised their primary taxing right, or the payment is otherwise subject to low levels of effective taxation. One of the main objectives is to ensure that the decision to be based in a country is made by companies for non-tax reasons.

India seems to be principally aligned with the Pillar Two proposals and may benefit with respect to offshore structures of Indian companies where their offshore income may become subject to Indian taxes. Revenue from such operations are not always repatriated back into India and retained offshore for further expansion or other business purposes. Tax advantages in the form or a 17% headline rate (in Singapore for instance) and an even lesser effective tax rate acts as an incentive for such structures due to which taxes on such incomes are not paid in India.

Therefore, any global minimum tax has the potential to neutralize the tax benefit and countries may then have to compete based factors other than a tax advantage such as better or stable regulatory regime, ease of doing business or access to global talent or resources amongst others.

The US had earlier suggested 21% as the global minimum effective tax rate, but on receiving backlash from several countries, the US has now reduced this rate to 15%. While this should increase the chances of reaching a global agreement, given that US has increased domestic corporate tax rate, it will be crucial to see whether the 15% minimum tax rate is able to secure Congress support. Presumably, the remaining obstacle for arriving a consensus is the around the remaining aspects around Pillar One.

D. What Next?

In the above context, it is clear that India is likely to push for wide application of the proposals. They had reportedly pushed for a Euro 1 Billion threshold that was intended to cover 5000 companies as opposed to 100. This was also done keeping in mind the interest of Indian companies such as TCS and Infosys. India is also reported to be in talks with other developing countries to secure a better deal and will want to ensure that they collect more money through Pillar I than currently collected by EL (INR 4000 crore since inception and INR 2057 crore in FY 2020-21). Towards that end India will push for a 30% allocation of the entire profits (as opposed to the residual profits that countries are agreeing to tax currently, which is profits over and above the 10% profit margin). Therefore, while India has committed to this deal, it is conditional and not a certainty that they will implement this. The chances of success have significantly increased and focus appears to be in the right direction at present.

The revenue sourcing rules are yet to be finalised. Prescriptive nature of the rules may still cause issues. However, there appears to be some acknowledgement of the fact that they need to be applied by MNCs through a reliable method in the Agreement. This is a significant compliance issue and further details are required to evaluate this. Impact on Indian companies also becomes a key concern with the widening of the scope of the Agreement. The UTPR rule allocates income to countries such as India from where the payments are made. There is a debate ongoing as to whether the IIR (which allocates income to countries where the companies are resident such as the US) or UTPR should be given the priority in the order of application. This appears to be an open point which India is likely to push for. Overall impact for MNCs should be minimal since this issue is in relation to allocation of taxes and should not increase the overall tax liability. Compliance issues, if any, could arise depending on the implementation of the final proposal under Indian law.

Eight countries have not agreed to this (Barbados, Estonia, Hungary, Ireland, Kenya, Nigeria and Sri Lanka) and others are also asking for more carve outs and exceptions. This may also have an impact on the stability of the deal.

Some of these proposals may have challenges in being accepted by the US Congress. This could also significantly impact the future of the deal.

E. Conclusion

It is clear that taxation of digital economy is in one of the prime concerns within the international tax community. While both the OECD and UN have made their recommendations, the future of digital taxation vests on political agreements and international consensus. Without fixing the structural issues, threshold problems, and allocation of a larger part of the tax base to low/mid income economies, it is unlikely, that states will do away with unilateral measures. Further, the COVID-19 pandemic has exacerbated the need for revenues for governments across the world. Unsurprisingly, not only there is a pressing need to bolster tax revenue, the digital economy offers an attractive source for deriving such revenue. Having said this, unilateral measures are facing heightened political tensions across the world with Section 301 Investigation giving rise to trade war like situations. While unilateral measures may have a disproportionately negative effect on high investment, low-margin businesses, along with creating the possibility of the additional cost being passed down to customers, from an Indian perspective, as discussed above, the EL is likely to be presumed to remain for now.

Against the backdrop of the pandemic and struggling economies, it is hoped that importance or rather necessity of encouraging trade and economic activity is prioritised over a disagreement regarding tax allocations. A tax related trade war or a further entrenchment of unilateral levies is likely to further harm both the global and national economies, including consumers. A less than ideal deal may still appear to be better than the next best alternative

– Vibhore Batwara, Arijit Ghosh, Ipsita Agarwalla & Meyyappan Nagappan

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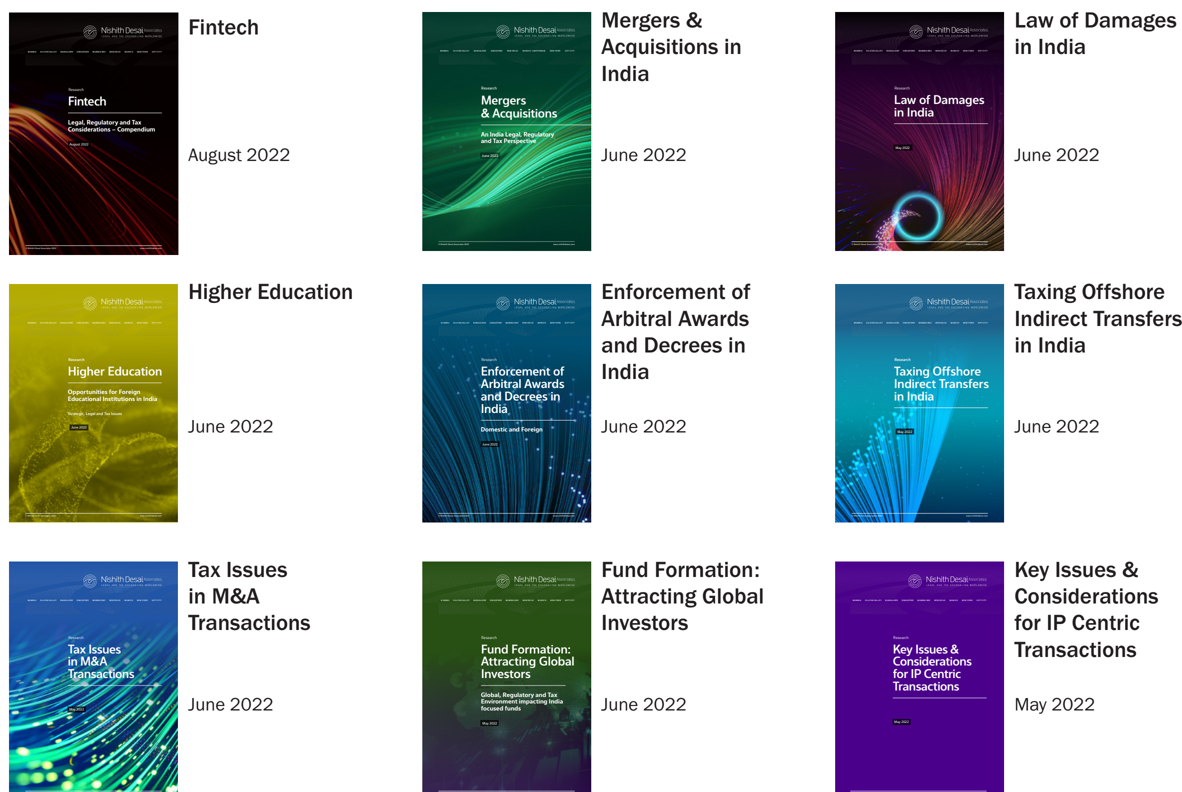

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