

Technology & Tax Series

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TECHNOLOGY & TAX SERIES – ISSUE IX: 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.¹ IBM has recently announced that it will turn corporate patents into NFT so that the patents can be easily sold, traded or otherwise monetized.² 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 2020.³ 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.

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 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 e-commerce 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.

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

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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.

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.⁴ 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.

Under the recently introduced section 194Q,⁵ 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.

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.⁶ 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

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You can direct your queries or comments to the authors

¹ 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-that-are-selling-for-up-to-millions-online/articleshow/81199814.cms>

² Chipolina, Scott. (2021, April 21). IBM Is Turning Patents Into NFTs. *Decrypt*. <https://decrypt-co.cdn.ampproject.org/c/s/decrypt.co/68501/ibm-is-turning-patents-into-nfts?amp=1>

³ Burch, Sean. (2021, April 3). NFT Market Surges 2,100% to \$2 Billion in Q1 Sales. *The Wrap*. <https://www.thewrap.com/nft-market-surges-2100-to-2-billion-in-q1-sales/#:~:text=More%20than%20%242%20billion%20was,a%20new%20report%20NonFungible.com>

⁴ Section 206C(1H) of the ITA; the provision comes into effect from October 1, 2020

⁵ With effect from July 1, 2021

⁶ Section 52 of the CGST Act, 2017

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