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Progression of Cryptocurrency: A Taxation Concern

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ABSTRACT

The Paramountcy of technology was set into motion with the advent of internet. Cryptocurrencies are progeny of such technology and internet. The public's adoption and use of cryptocurrencies has skyrocketed in the last decade.

Cryptocurrencies like bitcoin are virtual currencies which function in a peerless network thereby eliminating the need for intermediaries. Its specific technological features, combined with a lack of regulatory guidelines, generate significant tax complications. Although there is still a lot of misconception as to taxation of cryptocurrencies, countries all over the world has begun to note the issues involved and have started to implement the necessary measures to curb tax evasion.

In case of India, The Blockchain technology opens up the realm of secure digital transactions in state. The Indian population has also shown significant interest in virtual currencies which is evident from the increasing number of investors and owners of crypto-assets in the country. Initially Indian government was unwelcoming of such crypto investments and trading owing to its ambiguous decentralised nature. There was even an umbrella ban on usage of cryptocurrency in the country. But with the advent of COVID-19 pandemic, investments in these virtual assets have taken over the global market like a tsunami, making cryptocurrencies an indispensable part of global as well as national economy. This had compelled the Indian government to step in and regulate the crypto market in order to ensure the economic growth of the country in par with other countries. The Indian government recently tabled a bill before the cabinet to regulate the crypto assets in the country.

With things turning up better for development of cryptocurrencies in India, this paper deals with taxation issues in the crypto currencies and the complications involved among various stakeholders. It also provides an analysis of measures adopted by other countries which could help in framing an effective policy for taxing cryptocurrency in India.

Keywords: *Cryptocurrency, Bitcoins, Tax on Bitcoins, India.*

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I. INTRODUCTION

“Bitcoins will do to banks, what email did to the postal industry”

- **Rick Falkvinge**

With Internet reigning its dominance over the world, there has been a tremendous increase in the value and usage of Cryptocurrencies among the global community. Though investing in cryptocurrency has become a new fascination among the people, many Governments and Central Banks around the world scorn upon the usage of cryptocurrencies owing to its lack of regulation. But this has not deterred business around the world, and many establishments have started accepting Bitcoins as a mode of payment. Thus, several Countries are already contemplating to regulate and approve cryptocurrency as legal tender while also analysing the impact of such currency on their economy and on the fiat currency of such country.

The wave of cryptocurrency-craze has struck the Indian population too. India holds the fifth position among the countries with highest number of crypto owners.¹ A recent report states that India’s crypto market has grown by 641% over the past year placing it as the second country in the Global Cryptocurrency Adoption Index.² In addition to this, in the recent COVID-19 pandemic, India had received relief fund worth Rs 22 crore in cryptocurrencies.³ These explicitly establish the indispensability of cryptocurrency in Indian economy.

During the initial days following the introduction of Bitcoin in India, a slew of cryptocurrency exchanges sprung up. However, they were operating in a regulatory vacuum. Not only was there no precise definition of what a cryptocurrency was, but there was no legislation prohibiting or regulating its usage as well. This condition persisted until April 2018, when the Reserve Bank of India released a circular prohibiting the provision of banking services to anyone dealing in cryptocurrencies. This basically meant that any exchange that allowed the use of cryptocurrencies was shut down. Despite this limitation, a large number of investors began trading cryptocurrencies on brand new online platforms in the hopes of quickly making a profit.

However, the never-ending craze of virtual assets piqued the attention of Indian regulators and tax authorities. The Indian government recently established an interdisciplinary committee, which includes the NITI Aayog and the Reserve Bank of India (‘RBI’), to examine the regulatory structure surrounding digital currencies in India. Furthermore, the Supreme Court quashed the aforementioned RBI circular on March 4, 2020.⁴ Moreover, the government is also under consideration to introduce a bill titled “The Cryptocurrency and Regulation of the Official Digital Currency bill, 2021” which aims at regulating virtual currency in the country

and also ponders into the possibility of introducing its own virtual currency named CBDC (Central Bank Digital Currency).

With Cryptocurrencies grabbing the centre of attention of regulators, it is high time we discuss the complications involved in taxing these crypto assets in order to come up a strong and definite regulatory and taxing policy in respect of such Cryptocurrencies in India.

II. OVERVIEW ON CRYPTOCURRENCY

(A) History of cryptocurrency

The concept of cryptocurrencies as anonymous virtual currency was first pioneered in 1983 by David Chaum.⁵ A decade later, A user named Satoshi Nakamoto introduced the digital currency with the help of a white paper, "Bitcoin: A Peer-to-Peer Electronic Cash System on October 31,2008.⁶ Nakamoto aimed to use the open-sourced network to generate a decentralized virtual currency where cryptography is used to authenticate such financial transaction. The presence of intermediaries such as the central bank was not required under this model.⁷

Over the past years, Various other cryptocurrencies have cropped up such as such as Ripple, Ethereum and Litecoin, Stellar etc, each using blockchain technology to record the transactions.

(B) Definition of cryptocurrency

While there is no legal definition for 'cryptocurrency' in India, the Oxford Dictionary defines 'cryptocurrency' as follows:

*"A digital currency in which encryption techniques are used to regulate the generation of units of currency and verify the transfer of funds, operating independently of a central bank."*⁸

The New York Department of Financial Services 2014 and the New York Department of Financial Services 2017⁹ and defines cryptocurrencies as,

"Any type of digital unit, created or obtained through mathematical calculation, whose system is based on the internet and which is used as a means of change or a form of digitally stored value".

(C) The functioning of cryptocurrency

Cryptocurrencies are decentralized virtual currencies. This means that there is no regulatory authority.

Currently the monetary system around the world is run by government issued Fiat currencies, the value of which is determined by a government decree.¹⁰ Such Fiat currencies are governed by a central regulatory body deriving their value from such sovereign authority.¹¹ The payment

process under this system profoundly depends on the financial institutions in the state.¹²

Unlike the fiat currency, the creation of new units and secure transaction of Cryptocurrencies are done using cryptography.¹³ They allow two parties to transact with each other securely, without a need for a trusted third party.¹⁴ The value of such currency are assigned by parties to such transaction as opposed to the usual practice where the value is derived from government fiat or gold.¹⁵

The crypto-currency ecosystem broadly involves several participants such as the miners, nodes, hash power rental companies who play a major role in the generation of cryptocurrencies using blockchain technology. The cryptocurrencies so generated as bought by traders or cryptocurrency exchanges who provide a platform for the casual consumer/customer who invests into bitcoins.

(D) Merits and demerits of cryptocurrencies

The essential advantage of digital currencies like bitcoin is that they function entirely on the basic principle of demand and supply, having no intrinsic value and no reserves.¹⁶ Thus, cryptocurrencies ensure transparent transaction with absolute anonymity. However, this unique character of cryptocurrency could also be a curse as it can be used for several illegal activities such as tax evasion, money laundering, illegal trading and terrorism funding. A recent example of anonymity of cryptocurrency aiding illegal activities is the May 2017 worldwide cyberattack by a ransom crypto-worm called ‘WannaCry’, which locked up data in around 230,000 infected computers and demanded a ransom in bitcoins.¹⁷ In addition to this, there are several other issues such as dearth of traders and merchants who accept cryptocurrencies, volatility in the value and delay in authorising the transaction etc.

III. TAXATION OF CRYPTOCURRENCIES

Cryptocurrencies in India are generated either through mining or purchased from any cryptocurrency exchange. The gains generated through this process can be taxed based on the nature of transaction and parties involved either under the Income Tax Act, 1961 or under Central Goods and Services Tax Act. Since the position of cryptocurrency in India is uncertain as to whether it is a good or currency, this article tries to analyse the taxation of cryptocurrency by considering them as both goods and currency.

IV. TAXATION OF CRYPTOCURRENCIES UNDER GOODS AND SERVICES TAX ACT, 2017

(A) Treatment of cryptocurrency as goods

The supply of cryptocurrency would be a taxable supply under GST if such cryptocurrencies are to be treated as goods/ property. But when such supply takes place in exchange for other goods(virtual/real), it shall be considered to be a barter transaction. However, supply as defined in section 7(1)(a) of GST includes barter.¹⁸ Hence, it is evident that even barter transactions are subjected to tax under GST. This leads to three conditions as follows:¹⁹

a. Transactions involving exchange of cryptocurrencies – any consideration received (either as money or others) in exchange of such cryptocurrency would be liable to charge under GST as such exchange shall fall within the ambit of supply of goods for consideration.²⁰ Any commission received as a part of such exchange would also attract the GST as the said commission is a consideration for the service provided.²¹

b. Transactions involving exchange of cryptocurrencies for goods and services – GST shall be charged on the transaction value of the cryptocurrencies as determined under Sec.15 of the Act. GST.

c. Transactions involving exchange of cryptocurrencies for goods and services through intermediary – Two separate transactions occur in this scenario. The first transaction happens between receiver and supplier of the cryptocurrency and second one occurs between the intermediary and the supplier of the cryptocurrency. Both these transactions are subjected to tax individually.

In all these scenarios, if the supplier is not registered under GST, tax would be payable on reverse charge basis by the recipient instead of the supplier, collecting the same on his behalf²² for which the said recipient is also required to get compulsorily registered.²³

(B) Treatment of cryptocurrency as currency

Though RBI has not recognised Cryptocurrencies as “currency”, it can be included within the definition of "such other similar instruments." under section 2(h) of the RBI Act.

Under the GST regime, Currency (including the foreign currency) is exempted from definition of Goods²⁴ and any pure monetary transaction cannot be included within the ambit of service.²⁵

(C) Mining of bitcoins: whether a Service under GST?

The definition of supply under GST requires that a supply of service must be done in furtherance of business for a consideration. It also mandates that the consideration received must be in connection with the service provided.²⁶

A miner of cryptocurrency carries out the mining activities to generate the cryptocurrencies which can be considered to be business under GST. Thus, any service provided by him to the

user of cryptocurrency shall be a taxable supply of service under GST, where the miner is the service provider, the user is the recipient of the service and computing power supplied in exchange for the bitcoins shall be the service.²⁷

The inability to identify the service recipient doesn't absolve the liability to pay tax under GST as such service recipient may be included within the ambit of the 'body of individuals' under the definition of person²⁸ and accordingly, the value generated would be considered to be inclusive of GST. However, an unsuccessful supply of computed power which doesn't receive any consideration in the form of bitcoins is exempted from paying tax under GST.²⁹

(D) Taxation Issues of cryptocurrency under GST

- *Double taxation of a transaction* – when a cryptocurrency is considered as goods, there are instances where it can get taxed twice (first on supply and secondly on consideration). This double taxation would increase the tax burden on the assessee's operating businesses. Further it acts as a deterrent to investments in cryptocurrency.
- *Valuation of cryptocurrency* – The value of cryptocurrency is fixed by transcribing the value of such currency into the relevant unit in fiat currency of the country. When a goods is supplied for consideration which is not wholly in money, the value for such shall be its open market value.³⁰ Accordingly, the market value would be the transaction value which is listed on bitcoin price index at the date of issuance of invoice or the date of payment, whichever is earlier.³¹ A purchaser may avoid tax by taking advantage of the volatile nature of cryptocurrencies by affecting invoice or making payment when the value is lower.
- *Jurisdictional issues* – In general, Ascertaining the tax jurisdiction is a major concern for any virtual transaction. The Anonymity of cryptocurrencies make it onerous to determining the place of supply in the virtual transactions. Thus, imposing the RCM provisions on the service recipient under GST is highly unlikely unless there is a voluntary disclosure of address by him.

V. TAXATION OF CRYPTOCURRENCIES UNDER THE INCOME TAX ACT

Income Tax Act (hereinafter referred to as ITA) is the major direct tax law governing the taxation of the cryptocurrencies in India. If bitcoins are considered as 'currency', it cannot be chargeable to tax under ITA as neither natural meaning nor the definition of the term "income" under section 2(24) of the ITA³² includes money or currency as such. Moreover, the tax incidence under ITA is the transaction involved and not the currency itself.

On the other hand, if bitcoins are considered as goods/property, then they either covered within the charging provision of ‘Profit and Gains from Business and Profession’³³ (in case of goods) or ‘Income from Capital Gains’³⁴ (property), depending upon whether it has been used for the purpose of business/profession or not.

(A) Treatment under the head ‘Capital Gains’

The wide definition of capital asset under ITA ensures that property of every kind is brought within the taxing ambit unless they are specifically exempted.³⁵ Hence, any gains arising from the transfer of bitcoins which was held for the purpose of investment, must be considered as capital gains, and shall be subjected to tax under Sec.45 of ITA.

Accordingly, any gains generated while transferring cryptocurrencies, where the asset had been held by the assessee for period of more than thirty-six months, shall be considered to be a long-term capital gains (hereinafter referred to as ‘LTCGs’) and chargeable to tax at rates specified under the Act.³⁶ When the asset is held for any period less than 36 months, tax would be determined as per the provisions relating to short term capital gains (hereinafter referred to as ‘STCGs’).³⁷ While computing LTCGs and STCGs, the cost of acquisition would be the market value prevailing at the time of creation/ purchase of bitcoins.

(B) Taxability under ‘Profit and Gains from Business and Profession’

A perpetual trading of cryptocurrencies is included within the definition of business under section 2(13) of the ITA.³⁸ Thus the profits arising from such trading of cryptocurrencies is taxable under section 28 of the ITA.³⁹ Also, any expenditure incurred for such trading, such as purchase of computing power as capital asset, can be claimed as deduction under section 30 to sec. 43D of the ITA.⁴⁰

Though the legality of bitcoins in India is yet to be determined by the Government, any income generated from their trading can be taxed under ITA as income tax no distinction between illegal and legal income.⁴¹

(C) Issues of taxing cryptocurrencies under Income Tax Act

- *Absence of Cost of Acquisition* - ‘Cost of acquisition’ in case of bitcoins is unascertainable as it is a self-generated asset generated by the miner by only using the computer capacity. In *CIT v. B.C. Srinivasa Setty* (‘B.C. Srinivasa Setty’),⁴² the Supreme Court held that where the COA is ‘indeterminable’ for an asset, the gains from such asset shall not be subjected to tax under capital gains. Applying this precedence to

bitcoins, there might be a possibility that the gain arising from the trading of such bitcoins is exempt from tax.

- *Lead to tax evasion and other illicit activities* – the virtual transactions of cryptocurrencies occur over several jurisdiction posing endless concerns for the taxing authorities. There is a lack of monitoring or reporting norms which makes it hard to know if any income is being generated and there is also no tax deducted at source, thereby flourishing into virtual tax havens. The lack of intermediaries makes the regulation of such currencies much more challenging as all the traditional practices to curb evasive activities proves to be ineffective for such novel technology.

VI. TAX TREATMENT OF CRYPTOCURRENCY IN OTHER COUNTRIES

- **USA** – cryptocurrencies are treated as property by the US Internal Revenue Service ('IRS') for the purpose of federal tax.⁴³ The regulation of cryptocurrencies to prevent money laundering and financing of terrorist activities have been curbed by the federal laws of USA by introducing both regulatory measures and statutory penalties.⁴⁴ The registration of unregulated financial institution have been mandated by the amended Bank Secrecy Act of 1970 ('BSA').⁴⁵ Current Transaction Reports ('CTR') and Suspicious Activity Reports ('SAR') are required to be filed by companies in case of any possible violations.⁴⁶ The Money Laundering Control Act, 1986 criminalises and imposes Statutory penalties on money laundering
- **European Union** - The European Union had declared in its draft legislation that cryptocurrencies are not to be anonymous and obligated the cryptocurrency service provider and custodian wallet operators to supervise and spot any dubious activities.⁴⁷
- **UK** – cryptocurrencies are considered to be asset or private money on which capital gains tax is levied. However, it is exempted under VAT.⁴⁸ The cryptocurrency exchange platforms were also brought within the purview of antimoney laundering regulations.⁴⁹
- **Japan**- Japan is the one of the few countries to grant recognition to cryptocurrency as 'real money'. This led to development of several innovative financial services.⁵⁰ Japan had also exempted the supply of virtual currencies such as bitcoin from Japanese Consumption Tax ('JCT') since July 1, 2017, which was earlier charged at the rate of eight percent.⁵¹
- **Australia**- In Australia, cryptocurrencies were taxable under GST as Intangible properties.⁵² However, this resulted double taxation of such currency (first during the

purchase of currency and second during the exchange of such currencies for goods or services). On September 14, 2017, the Department of Treasury introduced a retrospective legislation exempting digital currencies from the purview of GST retrospectively and considering it to be the usual physical money for the purpose of GST.⁵³

VII. CONCLUSION

The cryptocurrencies have become the money for global community. The rise of cryptocurrency as an alternate for fiat currency accentuates the significance of cryptocurrency in the economic development of a country. The current regulatory ambiguities and uncertainty in taxation of cryptocurrencies affects the interest of entrepreneurs, investors and miners in India and also puts a damper on any foreign investment. The lack of proper taxing provisions also leads to money laundering and offshore tax havens.

The issues in cryptocurrencies are very much similar to those issues the traditional cash transaction. So outright banning and repulsive approach to such novel technologies would only hinder the growth of the countries. The government will need to be harmonize the disruptions of technology in the law enforcement and also ensure the technological advancement of the country in all aspects. Rather than suppressing the usage of bitcoins, the government can establish a regulatory authority which can be authorised to decide all the disputes involving cryptocurrency and also lay down disclosure norms, anti-money laundering standards for transaction involving cryptocurrencies. It is also the need of the time to revamp our existing taxation laws and cyber laws to overcome the shortfalls of bitcoins.

The wave of digital currency and e-transactions have already taken over the global market. Therefore, its high time, India reflected upon its legal lacunas and ensure our position in the global race for development and dominance.

VIII. ENDNOTES

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22. *Id.*, section 9(4).
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30. The Goods and Services Tax (Determination of Value of Supply) Rules, 2017, Rule 1(a).
31. The Central Goods and Services Tax Act, 2017, Section 12(2).
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33. The Income Tax Act, 1961, section 28.
34. *Id.*, section 45(1)
35. The Income Tax Act, 1961, section 2(14).
36. See the Income Tax Act, 1961, section 112 (The rate of tax for Long Term Capital Gains is twenty percent).

37. In case of non-equity capital assets held for short-term, Short-Term Capital Gains on such funds are taxed as per the slab rates of individual investor.
38. Id., section 2(13).
39. Id., section 28 (Charging Provision provides a list of incomes that are chargeable to tax under the head 'Profits and Gains from Business and Profession').
40. These provisions deal with expenditure allowed as deduction under sections 30-37(1) as well as specific allowances and disallowances under the Income Tax Act, 1961.
41. CIT v. K. Thangamani, 2008 SCC Online Mad 1102: (2008) 309 ITR 15, 22.
42. CIT v. B.C. Srinivasa Setty, (1981) 2 SCC 460; See also R. Dalmia v. CIT, 1981 SCC Online Del 388: (1982) 133 ITR 169 (The High Court observed that, "Capital gains have to be included only at the time they are ascertained. If there are gains, they should be known").
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44. Money laundering is a process whereby funds obtained illegally are rendered clean so that they may be used for legal activities. Contrarily, terrorist financing is a similar process, the sole difference being that legal money is used for illegal activities. However, both are considered under the ambit of 'money laundering' under Prevention of Money Laundering Act, 2002, in India.
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