



Cryptocurrency and its Likely Tax Treatment in India

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Introduction

Cryptocurrencies remain a hot topic of discussion several years after they were dismissed as a 'bubble' by various pundits across the world. Though there is no law that prohibits the buying and selling of cryptocurrencies in India, the same is not considered legal tender and the Government of India is rather circumspect in respect of ever accepting the cryptocurrencies as legal tender. Most regulatory bodies seem to be of the view, at least in India, that on account of their virtual nature, the risk of the same being used to finance illegitimate activities or even for the purposes of money laundering is very high and hence should not be encouraged. The main concern of the government is that cryptocurrency is highly volatile. It is decentralized and therefore neither regulated nor protected legally. The chances of it being recognised as legal tender in the future remain dim. Due to the lack of a regulatory and legislative framework to deal with cryptocurrencies, the Indian Government is losing out on substantial revenue as India is an emerging market of cryptocurrency in the global scenario. Therefore, if a change has to be brought, the Income-tax Act, 1961 would be a good starting point.

A General Idea of Cryptocurrency

Though the definition of cryptocurrency is rather complicated and vexatious due to the vagaries of the aims and objectives of the

authorities responsible for defining the same, the simplest place to start would be the following:-

- (i) *As per Oxford dictionary, "a cryptocurrency is defined as "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.*
- (ii) *The Merriam Webster dictionary defines cryptocurrency as under:*

"any form of currency that only exists digitally, that usually has no central issuing or regulating authority but instead uses a decentralized system to record transactions and manage the issuance of new units and that relies on cryptography to prevent counterfeiting and fraudulent transactions.

A technical definition can be taken as given by the Financial Action Task Force (FATF) which, in a report in 2013, defined 'Virtual currency' as a digital representation of value that can be traded digitally and functioning as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but not having a legal tender status. The FATF report also defined 'cryptocurrency' to mean a math-based, decentralized convertible virtual currency protected by cryptography by relying on public and private keys to transfer value from one person to another and signed cryptographically each time it is transferred.

The above definitions thus make it clear that a cryptocurrency is, therefore, not a traditional 'currency' but is a virtual or digital representation of money's worth and not something which is available in a tangible and physical form. A cryptocurrency is based on a block chain technology. A block chain technology is a distributed ledger which is open and records all transactions in code. In a simpler sense it's a kind of cheque book that's distributed across countless computers all across the world.

There are two ways in which these cryptocurrency transactions are verified before they are added to the block chain. It is 'proof of work' and 'proof of stake'. Proof of work is a method in which the transactions are verified on a block chain where an algorithm provides a mathematical problem and different computers race to solve it. These participating computers are often known as miners. Mining is a validation of transactions. Successful miners obtain new cryptocurrency as a reward. The reward decreases transaction fees by creating a complementary incentive to contribute. Some miners pool resources, sharing their processing power over a network to split the reward equally, according to the amount of work they contributed to the probability of finding a block. A "share" is awarded to members of the mining pool who present a valid partial proof-of-work. But because this race to finish first by the miners requires a large amount of computer power and electricity it could be a possibility that these miners barely break even after considering the cost of the computer resources and cost of power. Therefore the second method is preferred i.e which is proof of stake.

The Regulatory History in India so far

The landmark case of the Hon'ble Supreme Court of India in the case of *Internet and Mobile Association of India v. RBI (2020) 10 SCC 274*, contains within its ambit a dissertation about 'virtual currencies'. The genesis of the case

details the Indian regulatory restrictions as well as guidelines issued from time to time by various authorities that cumulated into the Reserve Bank of India issuing a "Statement on Developmental and Regulatory Policies" on April 5, 2018, which directed the entities regulated by RBI (i) not to deal with or provide services to any individual or business entities dealing with or settling virtual currencies and (ii) to exit the relationship, if they already have one, with such individuals/ business entities, dealing with or settling virtual currencies (VCs). Following the said Statement, RBI also issued a circular dated April 6, 2018, on the same subject, in exercise of the powers conferred by Section 35A read with Section 36(1)(a) and Section 56 of the Banking Regulation Act, 1949 and Section 45JA and 45L of the Reserve Bank of India Act, 1934 (hereinafter, "RBI Act, 1934") and Section 10(2) read with Section 18 of the Payment and Settlement Systems Act, 2007, reiterating the directions laid down by the aforementioned Statement.

It is perhaps beyond the scope of this article to dwell upon the regulatory scheme how it cumulated into the said circular that was impugned before the Hon'ble Supreme Court, suffice to say, the Government had, from time to time, through various organs and agencies, applied their mind to the form of regulatory, legal and operational risks that were posed by the advent of Virtual currencies. The RBI, in their Financial Stability Report of June 2013, gave us arguably the first Indian definition of virtual currencies "a type of unregulated digital money, issued and controlled by its developers and used and accepted by the members of a specific virtual community." The definition is quite vague, but apt. The efflux of time from 2013 has given us the benefit of hindsight, but the origins of virtual currency and their effect on the established world order were unknown. The RBI issued press notices cautioning the users, holders and traders of virtual currencies about the potential financial, operational, legal

and customer protection and security related risks that they are exposing themselves to. The Press Release noted that the creation, trading or usage of VCs, as a medium of payment is not authorized by any central bank or monetary authority and hence may pose several risks.

The Hon'ble Court was pleased to observe that though Virtual currencies, or cryptocurrencies in common parlance, themselves were not banned, the trading in and the function of the exchanges were sent to comatose by the impugned circular by 'disconnecting its lifeline' being the interface with the regular banking sector, even without the RBI not finding anything wrong with the way in which the exchanges function. It was specifically observed that the Government of India was unable to take a call regarding the banning of cryptocurrencies despite several committees coming up with several proposals including two draft bills (both of which advocated exactly opposite positions). In the light of these observations, amongst others, the Court set aside the impugned circular on the ground of proportionality.

The Dilemmas of Classification

This would therefore denote that we are back to the position of the 'Square one', where the cryptocurrencies are not banned but are not specifically regulated as a specific class of assets/ instruments. The Indian government is in the process of drafting a formal bill to draw up a structured and regulatory framework to regulate the cryptocurrency market. But until the same is done, the taxation implications of dealing in cryptocurrency would possibly be almost as varied and uncertain as the number of headings for computing Income under the Income-tax Act, 1961 (hereinafter referred to as the "Act").

A primary reason for embarking upon the exercise to try and analyse the nature of cryptocurrency, is to determine it's nature for the purpose of taxability. Tax jurisprudence over

the ages always asks the same fundamental questions. What is it? Is it tangible? Where is it located? How has it been manufactured? How has it been purchased? How has it been transported? How does it derive value? And the most important question of all – What is the nature of Income?

A cryptocurrency by its very nature is intangible and can't be held in its physical form. There is no provision as yet in the Act which defines or categorizes under which provision, a cryptocurrency would fall. One thing is for certain, in the Indian context, the term 'cryptocurrency' is a misnomer. There may be no explicit ban upon cryptocurrencies, but as they are explicitly not legal tender and therefore, they are not currency or money. This exclusive analysis is critical at the outset as it demonstrates that a cryptocurrency is not money by itself and cannot be treated as such. It is the market and only the market that can determine the value of a cryptocurrency. Undoubtedly, Section 2(24) of the Act defines 'Income' is broad and exhaustive enough to net within it's tentacles, the money's worth that is ascribed to the cryptocurrency based on the transaction.

The possible Income-tax implications could be classified into various heads of Income:-

1) Profits and gains of business or profession

The term "business" as envisaged under section 2(13) of the Act. Section 2(13) of the Act reads as follows:

"business" includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture,

The first and obvious candidate to be subject to Indian Income-tax under this head of Income, would undoubtedly, be the Indian 'miner'. The mining activity by itself gives rise to the cryptocurrency, by consuming copious amounts

of computing power and resources. The resultant cryptocurrency from this activity could be classified as 'goods'. The Sale of Goods Act, 1930, provides that the term 'goods' means any kind of movable property other than actionable claims and money. The development, design, programming, customization, adaptation, upgradation, enhancement, implementation of information technology software shall be treated as supply of services as per the Central Board of Indirect Taxes (CBIC) and Customs as published in their 'frequently asked questions' (FAQs) dated 15.12.2018. The CBIC vide its sectoral FAQs on Information Technology ('IT') and IT enabled services had reiterated that in terms of Schedule II of the CGST Act, *'upgradation and implementation of information technology software or permitting the use or enjoyment of any intellectual property right are treated as services. But, if a pre-developed or pre-designed software is supplied in any medium/storage (commonly bought off-the-shelf) or made available through the use of encryption keys, the same is treated as a supply of goods...'*

Having already gone into the nature of cryptocurrency and its 'mining', it is clear that the process for the generation of the same is by and large standardized. It would therefore not be appropriate to classify it as a supply of service, even if the 'mining' activity itself contributes to the blockchain itself in a unique way by resolving queries. Most 'miners' would be investing Capital in the form of processing infrastructure through peer-to-peer networks and energy to power the same, without being actively involved in the technical aspects of the manufacture of the cryptocurrency. Regardless of whether the 'mining' of cryptocurrency is goods or services, it would un-doubtly be taxable at the point of sale under the heading 'Profits and Gains of Business and Professions'. It is the view of the authors that given the completely virtual nature of the cryptocurrency, it would perhaps be the geographical location in which the cryptocurrency is mined that can be considered the 'situs' of the cryptocurrency for the first

time. The tax treatment for cryptocurrency that is 'mined' in India and then sold in India or overseas would be reasonably straightforward for the tax authorities to take a call on, however, given the virtual nature of cryptocurrency and the peer-to-peer nexus between the 'mining' it is possible that the location for the mining be not determinable. This would directly impact the taxability of the cryptocurrency with respect to issues in international taxation and recourse may be required to double taxation avoidance treaties etc. to be able to determine taxability on a case-by-case basis. The miner has to make investments in the form of computing resource and electricity etc. into the mining activity and therefore, can claim the computer resources deployed towards mining as a Capital 'Plant and Machinery' while the electricity bills and other expenses including the bandwidth charges may be claimed as revenue expenditure.

The second side of the coin as far as profits from business and profession income is concerned is the treatment of the income earned from trading of cryptocurrency. Cryptocurrency, just like the stock market tends to fluctuate in value by the minute and this makes it an attractive opportunity for trading in addition to mining. Trading is less resource intensive than mining and does not come with any associated costs, except for the risk that is taken up by the trader due to fluctuations. With a sheer number of cryptocurrencies coming on the market from time to time, the trader in cryptocurrency seems to be spoilt for choice when it comes to trading. Trading however, brings with it a high chance of a cross border element, given the virtual nature of cryptocurrency and its ambiguous geographic location. This could lead to various questions with respect to International taxation especially for cryptocurrency that is traded globally on cryptocurrency exchanges

The Supreme Court, in a recent decision in the case of *Engineering Analysis Centre of Excellence Private Ltd. v. CIT 2021 SCC Online SC 159*, held that amounts paid by resident Indian

end-users / suppliers as consideration for the resale / use of the computer software through distribution agreements is not the payment of royalty for the use of copyright in the computer software and therefore the use of the copyright in the software does not give rise to any taxable Income in India (as royalty). This Judgement perhaps could shed some light upon the taxability of 'cryptocurrency', especially with regards to the deduction of tax at home. For miners collaborating in India, where one person (Resident) provides resources for mining to another in pursuance to any understanding (offer and acceptance coupled with consideration)/ contract deduction of tax at source may be required to be made as envisaged by Section 194C, similarly if a Crypto exchange is set up in India or if a resident Indian assists in the transfer of Crypto currency and charges brokerage for the same, deduction may be required to be made as per Section 194H of the Act. Section 194-O as made applicable to payment of certain sums by e-commerce operators to e-commerce participant may also be applicable on a case to case basis and in the case of payments to non-residents, Section 195 read with the relevant double taxation avoidance agreements may be applicable. The deduction of tax at source, if required, would depend upon the factual matrix of each transaction.

The introduction of the 'Equalisation Levy' (Chapter VIII) also brings the possibility of fresh implications for the purchase of cryptocurrency that is purchased from abroad: Section 164(cb) (i) has the potential of being squarely applicable to the trading of cryptocurrency while Section 164(ca) has the possibility of being directly applicable to the cryptocurrency exchanges / institutional sellers as well as individual sellers etc. that are selling cryptocurrency online. The effect of the equalisation levy, if applicable shall perhaps be discernable in more detail once exhaustive rules, etc. are made, however, the use of equalisation levy to bring the transfer of cryptocurrency within the tax net (even

during purchase) cannot be ruled out. This, if implemented, can be a cause for concern in the unregulated marketplace for cryptocurrency, but shall pave the way for those cryptocurrency exchanges working on an institutionalized framework to be compliant with Indian tax requirements.

2) Capital Gains

It is a well-established fact that given the rapid advent and the rise in the price of cryptocurrency, there are individuals and entities that look towards cryptocurrency as a Capital Asset in order to 'invest' into the rising market. The definition of Capital Asset is contained within the Act and includes *'property of any kind held by a person, whether or not connected with his business or profession'*;

The term 'property', though has no statutory meaning, yet it signifies every possible interest which a person can acquire, hold or enjoy. Going by the above definition a cryptocurrency can be held to be an interest that person acquires or enjoys in a property. A cryptocurrency would therefore, fall under the definition of 'capital asset', as defined under the Act.

Nature of holding

Once it is established that a cryptocurrency may be a capital asset in the hands of the person who holds it, the tax treatment of the same will depend on the frequency of transactions and whether the same is held as a 'stock-in-trade' or as an 'investment'. The parallel could be loosely drawn to whether the activity of trading in shares is a business or Investment. If the cryptocurrency is held as stock-in-trade and the person holding it trades in them regularly, then the gains made from it can be taxed as 'business income'

Hence a person could be involved in the business of trading in cryptocurrency and the gains made therefrom could be taxed as 'business income'. It is also relevant to note that certain possibilities do exist of trading in currency 'futures'. Trading

in cryptocurrency futures could be considered a 'Speculative transaction' as envisaged by Section 43(5) of the Act as the definition of the word 'commodity' could be construed to be of a wide enough import to contain cryptocurrencies within its fold.

On the other hand if a person hold the same as investments and the frequency of the transactions is not regular, then the gain from the same will be taxed under the head 'capital gains', as the same is a capital asset involving transfer and gains on the same are made. If the cryptocurrency is held by the person for less than 36 months, then the gain therefrom will be taxed as short term capital gain and if it is held for more than 36 months, then the gain therefrom will be taxed as 'Long term capital gains'. In the absence of specific guidance of the Central Board of Direct Taxes (CBDT) as available in the case of share trading activity, it is the general principles of the period of holding, frequency of trading, size of holding as well as treatment in books of accounts that shall be relevant for the purposes of establishing whether the gain from the sale of cryptocurrency shall be assessed as Income of Business or Income from Capital Gains. There can be no one size fits all formulae. The conclusion would have to be arrived at based on the relevant matrix of fact in each case.

There is also the view that crypto currency can be considered as a self generated asset that does not have a cost of acquisition. This would especially be a view taken by those miners who hold the crypto currency as 'investments' and long term assets and not 'stock in trade'. The Supreme Court in the case of *CIT v. B.C. Srinivasa Setty [1981] 128 ITR 294 (SC)* the

Hon'ble Court dealt with the case of goodwill generated in a new business. It was held that for the purpose of Capital gains, what is contemplated is an asset in the acquisition of which it is possible to envisage a cost. However, the nature of goodwill being fundamentally different from the nature and manufacturing process of crypto currency (generation of crypto currency is not automatic and is a deliberate process), it would be difficult to stretch the ratio of the B.C. Srinivasa Setty to the sale of crypto currency held as investment.

Income From Other Sources

Section 56(1)(ib) makes "any winnings from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever" as an income from other sources.

It is no news that cryptocurrency is highly volatile in nature. Just like fiat currency it is not backed by any asset or currency, therefore it is valued at what investors are willing to pay for it. Which means its price can be easily swayed.¹ To give the reader an idea of volatility- Elon Musk, CEO of Tesla and SpaceX and a supporter of cryptocurrency has influenced the value of bitcoin and other cryptocurrency on more than one occasion just by tweeting about them, so much so that the internet started to call it the "Musk effect"². On a similar note, another cryptocurrency named "Dogecoin" was created as a joke in 2013 based on the then popular 'doge' meme that portrays a shiba inu dog alongside multicolored text in comic sans font.³ A LiveMint.com article reported that 'popular cryptocurrencies such as Bitcoin

1. Why India's central bank has no faith in cryptocurrencies- <https://qz.com/india/1977698/why-rbi-is-concerned-about-bitcoin-other-cryptocurrencies/#:~:text=Money%20laundering%20and%20security%20concerns,of%20the%20owner%20is%20concealed>
2. Elon Musk Can't Stop Tweeting About Dogecoin and Meme Cryptocurrency's Volatile Price is Proof- <https://www.news18.com/news/buzz/elon-musk-cant-stop-tweeting-about-dogecoin-and-meme-cryptocurrencys-volatile-price-is-proof-3460184.html>
3. Tweets from Elon Musk and other celebrities send dogecoin to a record high <https://www.cNBC.com/2021/02/08/tweets-from-elon-musk-and-celebrities-send-dogecoin-to-a-record-high.html>

gained 800% while Ethereum is up 1,242% till date. A pragmatic view that the taxation of cryptocurrency may move beyond the realm of business profits and capital gains and move into the realm of 'Income from other sources'. There is a palpable sense of mistrust in cryptocurrency, given that new currencies erupt and burst into bubbles on a regular basis. There are a very few cryptocurrencies that are stable, and they have already enched upon their stage of rapid ascent to the top. Unestablished cryptocurrencies that come up from time to time and swell in value, giving outlandish returns and then disappearing into the night is not a far fetch in the cryptocurrency world where regulation is still trying to catch up to enterprise. The tax authorities therefore would perhaps not be amiss in trying to tax gains, specially from the little known cryptocurrencies as income from gambling/ betting, especially when adhoc investments are shown in a disorganized fashion without a structure and method to show that a systematic business / investment activity was being carried out.

Conclusions

The benefit of hindsight is a blessing in as much as it establishes that cryptocurrencies /

virtual currencies etc. are here to stay and are not merely a passing fancy or a tech bubble. Block chain technology has a variety of uses and is being deployed for a variety of purposes and the reputed cryptocurrencies (especially bitcoin) have managed by and far managed to hold on to 'moneys worth' instead of being seen as a tech bubble. Within the taxation and regulatory aspect, the challenges are immense including the question of cryptocurrencies remaining offbook, being traded on one on one basis, invoking the wrath of the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015, if located abroad as well as the second proviso to Section 147 of the Act (Income escaping Assessment). The tax treatment of cryptocurrency in the Indian context is yet a grey area in as much as it is open to interpretation in absence of even the basic guidelines to give certainty to the topic. It is hoped that the Government comes up with specific provisions that deal with this special class of 'goods' in order to determine the tax treatment that is the most desirable and free from ambiguity. (Note: Research assistance was provided by Ms. Aasavari Kadam, Advocate)



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