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Regulation and Taxation of Bitcoins in India: An Analytical Study

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ABSTRACT

Bitcoins have been in talk lately due to their high prices and the rise in their exchange. Indians were attracted to bitcoins from its primary years of creation and its demand increased significantly after demonetisation. However, the non availability of crypto exchanges and other restrictions in the country have prevented the growth of investment in bitcoins.

The authors in this paper while briefly discussing the mechanism of bitcoins also highlight how they function. The authors then move on to discuss the current regulatory system of bitcoins in India. Owing to their ever changing business models and the intricate technology involved, tax regulators as well as authorities have not been able to clearly answer many issues as discussed throughout the paper. Further, the authors have discussed the taxation structure of bitcoins in India. Exchange of bitcoins may be in the form of either income or expenditure and depending of the transaction they may be taxed under the "Income tax Act" or the Central Goods and Services Act. The authors have analysed the various characteristic features of bitcoins and why their taxation structure poses great complications. Under direct taxes the author has analysed the treatment of bitcoins in two ways namely "capital gains" and as "profit and gains from business and profession". The authors have given an overview of the taxation structure of bitcoins by focusing on both the direct as well as the indirect taxation structures. The findings of the authors will help to clearly assess the prevailing regulatory framework of bitcoins in India.

When compared to the other laws, the legislations relating to taxation must be more flexible and must continuously evolve to adapt to the new conditions in order to prevent the evasion practices. Although the future of bitcoins in India is not known, its success in the country is a possibility which demands serious thought.

Keywords: Bitcoins, regulation, taxation

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I. Introduction

With the beginning of the internet ear, the world changed drastically paving a way for a new age of technological advancements. Now, with the increase in the exchange of cryptocurrencies in the world, we stand at the beginning of a new era. "Cryptocurrencies" can be defined as an internet based medium of exchange which utilizes cryptographical functions in order to conduct its transactional functions. They utilise the blockchain technology to ensure transparency, immutability and decentralisation. Cryptocurrencies can be sent from one party to another by way of a private and a public key. These transactions involve minimum processing fees making them suitable for customers to avoid high amounts of fees charged by traditional financial institutions.

Cryptocurrencies are being used widely around the world making them known to most people. Due to the high prices at which they are exchanged, they have also come under the tax radar. Owing to the rapid technological changes involved in the blockchain technology forming the base of cryptocurrencies, tax regulators are facing difficulties in respect of certain issues. The author aims to highlight the issues which remain unsolved in this field of technology.

There are numerous cryptocurrencies in function, "bitcoin" being one of the most popular one of them. Bitcoin, also a digital currency, was created in January 2009. Bitcoins are primarily computer files which comprise of data which is almost identical to any media or text file. Bitcoins are created by way of a process known as "mining".[3]In the process of mining, the "miner" uses software running on a specialised hardware to carry out and process the transactions. This is basically a mathematical process in which each corresponding process has a higher difficulty level than the former.[4]

Two main issues arise while discussing the use of bitcoins- 1) privacy and 2) counterfeiting. The matter of privacy is settled by way of "public-key encryption", which is a process involving two keys which are linked mathematically, namely the private and the public key, to encrypt and decrypt transactions. Though all these transactions take place publicly, there is nothing that ties the individual or organisation transacting to the bitcoin, thereby ensuring optimum privacy and user anonymity. The next issue of counterfeiting is settled by

[3] How Bitcoin Mining Works, The Economist,*available at:*https://www.economist.com/blogs/economist-explains/2015/01/economist-explains-11 (last visited on November 3, 2020).
[4] David Lee KuoChuen, "Handbook of Digital Currency - Bitcoin, Innovation, Financial Instruments, And Big Data", (2015).

upkeeping a non-modifiable public ledger for all transactions.[5]

Apart from these, few of the other common issues include scarcity of vendors and merchants transacting in bitcoins, fluctuations in value, delays in verifying transactions, terrorist financing, money laundering etc. Many cases of security violations in bitcoin exchange and hacking of wallet operators have also been recorded. However, these issues have not affected the growth of use of bitcoins.

The regulation of bitcoins in India is also an issue. Two petitions were filed simultaneously in the Supreme Court in the year 2017, one seeking to restrict the buying and selling of cryptocurrencies in the country and the other seeking to regulate the cryptocurrencies in India. Thereafter, various press releases were made by the RBI and the Finance Ministry cautioning the people about the risks involved in the exchange of cryptocurrencies. However, everything changed once the RBI released the circular in the year 2018, preventing Commercial and Co-operative Banks, NBFCs, Payments Banks, Payment System Providers and Small Finance Banks from dealing in virtual currencies and also directing them to stop providing services to all parties which deal with virtual currencies.

The regulation of bitcoins currently in India shall be discussed in detail by the author in the paper. The author also aims to highlight the taxation structure of bitcoins in India both under direct and indirect taxes.

II. BITCOINS AND THEIR FUNCTIONS

Bitcoins are primarily computer files which comprise of data which is almost identical to any text or media file which are created by way of a procedure known as "mining". Under this process, the miner, processes a transaction by running a software on specialized hardware. This process can be said to a type of process for discovering new bitcoins. The process of mining is nothing but a mathematical process which is almost identical to discovering prime numbers in a given set of rational numbers. Even though it is easy to find the smaller prime numbers, the difficulty arises when one moves towards finding the larger prime numbers. On the basis of the design of bitcoins, an approximate number of twenty-one million bitcoins are expected to be created which is assumed to be mined in the next ninety-five years keeping the supply of bitcoins constant.[6] Due to the continuous supply and the increase in the demand for bitcoins, the price is gradually increasing.

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[5]Hatim Hussain, "Reinventing Regulation: The Curious Case of Taxation of Cryptocurrencies in India", 3 *NUJS Law Review* (2017).
[6]*Supra* note 2.

When a user carries out a transaction using bitcoins, it is locked with a virtual padlock forming what is called "blockchain" which is a decentralised ledger available to the public that records such transactions.[7] A new bitcoin is discovered when a key to the padlock, known as "hash" is found by a miner. The miner upon finding the "hash" checks and verifies the authenticity of the transaction. Once this bitcoin is produced, it can be used to transact with real currency on the basis of the current exchange value. This is then transferred to the purchaser's wallet. There are two keys available with the purchaser, one is the public key which is available with everyone to track the online activities using the wallet and the other is the private key which is used by the purchaser for completing transactions.[8]

III. REGULATION OF BITCOINS IN INDIA

The Reserve Bank of India vide its circular passed in the year 2018 prohibited by a bank or financial institution from dealing in as well as providing services involving digital currencies.

Two separate writ petitions were filed challenging the validity of the circular. It was contended that the RBI did not have the power to pass such a circular regulating digital currency in the country as they do not fall within the ambit of the RBI Act, Banking Regulation Act and the Payment and Settlement Systems Act, 2007 (PSS Act). Moreover, the circular was passed erroneously without taking into consideration relevant facts. Further it was contended that dealing with digital currencies falls within the purview of Art. 19(1)(g) of the Constitution of India which assures the right to carry on any occupation, trade or business.

It was noted by the Court that various actions were taken by the RBI over a 5-year period preceding the passing of the circular to prevent itself along with the other financial bodies from the risks auxiliary to digital monies. Hence, it cannot be said that the RBI has not applied its mind or not taken material facts into consideration while passing the bill. Also, it was highlighted by the Court that the RBI had the power to issue direction to the other financial bodies from dealing with digital currencies under §18 of the PSS Act. It was also pointed out by the Court that the action of the RBI was in the interest of the public and was done in good faith. However, the Court observed that the notice failed the proportionality test under Art. 19(1)(g). The RBI deprived businesses dealing in digital currencies from gaining access to financial institutions even though digital currencies are not illegal in the country. Moreover, the RBI did not find any wrongdoing on part of the digital currency exchanges.

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[7] CoccoL., Marchesi M, *"Modelling and Simulation of the Economics of Mining in the Bitcoin Market"*, (2016).
[8] Brian Kelly, *"The Bitcoin Big Bang - How Alternative Currencies Are About to Change the World"*, (2015).

Hence, the Court concluded that although there was no evidence of harm being caused to businesses dealing with digital currencies as a result of the circular, depriving such businesses from accessing financial bodies would be disproportionate as such currencies are not banned in India.

However, with decision of the Court, a vacuum has been created and no law in the country currently regulates digital currencies.

IV. TAXATION OF BITCOINS IN INDIA

The Parliament as well as the State Legislatures have been granted the power to levy taxes under Art. 246 of the Constitution of India. Further, by virtue of the one hundred and first constitutional amendment in 2016, amendments were made by the Parliament in relation to implementation of GST and also exclusive powers were granted to the Parliament to make laws relating to imposition of GST on interstate trade and commerce.

Any transaction that includes bitcoins can be viewed from two perspectives- a) income and b) expenditure. Depending on the transaction, it would either be treated under the Income Tax Act or the Goods and Services Act.

Treatment Under Indirect Tax

Two main methods exist for obtaining bitcoins- either through way of mining or through bitcoin exchange. Both these methods warrant different taxation processes in India. The first step in doing so is to classify bitcoins as currency or goods/services. The former would mean that it would not be taxable. Hence, the author tries to analyse the taxation of bitcoins as goods and services which would mean that it would attract the Goods and Service Tax (GST). The implementation of the GST in India from July 2017 has rendered a more complicated method for the treatment for cryptocurrencies under indirect tax.

Considering bitcoins to be goods, it would be taxed under the GST as "taxable supply". However, if they are exchanged for other properties (whether virtual or real) it would come under the definition of "barter". Prior to the implementation of the GST, the incidence of tax arose when there was any sale of goods in exchange for cash, deferred payment and any other valuable consideration.[9] The term "any other valuable consideration" had been interpreted by the Court using the ejusdem generis rule in the case of *Sales Tax Commissioner v. Ram Kumar Agarwal*[10]. The Court in this case observed that the meaning of the term would have

[9] R. Vasanthagopal, "GST in India: A big leap in the indirect taxation system", *International Journal of Trade and Economics* (2018).
[10] (1967) 19 STC 400 All.

to made out by considering the two immediately preceding terms, (cash and deferred payment) to not include the exchange of goods for other goods.

However, this ambiguity had been cleared by the enactment of GST under which tax is levied on "supply of goods or services or both"[11]. The term "supply" includes "barter made or agreed to be made for a consideration in the course of furtherance of business".[12]

Under this scenario, three situations may arise-

- Transactions entailing exchange of bitcoins,
- Transactions entailingtrade of bitcoins for other goods and services, and
- Transactions entailing exchange of bitcoins for other goods and services via intermediaries.[13]

Any transaction that involves the trade of cryptocurrencies for money or vice versa would attract GST, assuming the parties to the transaction being registered and residing within the territory of India. Any commission charged for the transaction would also attract the same for the reason being that such a transaction would fall within the ambit of "supply of goods and services of consideration"[14]

Under the next scenario, involving the exchange of bitcoins for goods or services, the entire transaction amount would be taxable under GST. When the same transaction is done through intermediaries, two transactions are involved, one between the supplier and the intermediary and second between the intermediary and the received. Both these transactions are separately chargeable under the GST.

This procedure for taxation comes with certain loopholes. Any transaction where bitcoins are considered as goods would mean that it would be taxable two times, first on supply and second on consideration. This leads to higher tax payable which in turn puts the businesses operating on bitcoins as a disadvantage parallelly damaging their purchasing power. This disadvantage is accentuated when the buyer or supply resides outside the territory of India.

Another issue that may arise is the issue of valuation of bitcoins. Under usual circumstances, the value of cryptocurrency can be set on by expressing its value at a given juncture into the appropriate unit of account of the concerned country. However, in case of bitcoin, its market value may not be the true and actual rendition of its assessable value since it does not fulfil a

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[11] The Central Goods and Services Tax Act, 2017, s. 9(1).
[12]The Central Goods and Services Tax Act, 2017, s. 7(1) a.
[13]RemertaBasson, "*An analysis of issues relating to the taxation of cryptocurrencies as financial instruments*", *Journal for Economics and Financial Sciences* (2020).
[14]The Central Goods and Services Tax Act, 2017, s. 7(1)(a), 2(52), 2(31).

reliable "store value" function.[15] Hence, a seller may not receive bitcoins valued equally to the value of goods. There may be a mismatch between the value one receives to the cost incurred by the party.

Under GST, when a service is provided by an unregistered party situated outside India to a registered party situated inside India, it would attract the "Reverse Charging Mechanism" (RCM). Under this mechanism, the recipient of the service is liable to pay the tax for the service instead of the service provider. It is necessary that such recipient must be registered compulsorily.[16] Determination of the place of supply has always been an issue since the recipient of the service is only needed to reveal his bitcoin address. Thus, unless the recipient of such service voluntarily reveals the place of supply, it is highly unlikely that the RCM would be complied with.

Treatment Under Direct Tax

Treatment of bitcoins under direct tax is mainly under the Income Tax Act. However, no direction or discloser requirements have been provided by the Income Tax department regarding the taxation of digital currency. If bitcoins are viewed as currency, they would not be taxable under the ITA as they do not fall within the definition of "income" and neither are they mentioned in the items listed under § 2(24) of the Act.

However, when bitcoins are viewed as acommodity or property, they would be taxed under the charging provisions of "Profits and gains from business and profession" or "Income from Capital Gains" contingent to whether they are considered as goods or as property respectively. In such a case the bitcoins must have been used for the motive of the business or profession.

Treatment under "Capital Gains"

Capital assets is defined under § 2(14) of the ITA. This definition of capital assets has a wide ambit and includes within its meaning all those types of properties except those expressly excluded. It does not include any kind of moveable property belonging to a person where the person has any kind of intimate relation with such property. Therefore, any such gains that arises from a transaction involving bitcoins which are being held for the purpose of investment must be considered as "capital gains". Suitably, if the holding time exceeds thirty-six months then it would be considered as "long term capital gains" and would be taxed

[15] *Supra*note 11.
[16] The Central Goods and Services Tax Act, 2017,s. 2(98).

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accordingly under the ITA[17]. On the contrary, if the holding period is less than thirty-six months then it would be considered as "short-term capital gains".

Treatment Under "Profits and Gains from Business and Profession"

The definition of "business" provided under § 2(13) of ITA is comprehensive in nature which includes within its ambit "trade, commerce or manufacture or any other adventure or concern of such nature".[18] Hence, the trade in bitcoins being a continuous activity would fall withing the ambit of this definition. Although in this case the profits are in the form of money, the profits are taxable even if they are realised "as kind".

As mentioned by the author previously, bitcoins have not been legally recognised by the Government till date. However, this does not have any effect on the taxability of the virtual currency as the ITA does not make legality a criterion for taxation. Thus, even if bitcoins are declared illegal later on, they would still be taxed despite the fact that they would be prosecuted for under the respective law.

V. CONCLUSION

By far an approximate of one-fifth of the Indian population is still unbanked. Under such a scenario, providing them access to the basic credit facilities and alternative banking instruments such as digital currencies would be very helpful due to its low cost of transaction, worldwide accessibility and secured infrastructure. As time passes by, the replacement of digital currency to flat currency seems more and more possible. Digital currency stands as a "near perfect" alternative to the traditional currency.

When compared to the other laws, the legislations relating to taxation must be more flexible and must continuously evolve to adapt to the new conditions in order to prevent the evasion practices. Although the future of bitcoins in India is not known but its success in the country is a possibility which demands serious thought. Currently there is no regulatory body in India which governs bitcoins let alone the taxation of the same. The Anti Avoidance Rule must empower the Tax Department to look over the transactions involving bitcoins entered upon for evasion purposes. It is suggested that Anti-money laundering or KYC norms which are applicable to financial bodies in the country to be extended to the digital currency exchanges and wallets. The author through this paper has discussed both the taxation under direct and indirect taxes considering bitcoins as both goods and currency. Nonetheless, a lot remains to

[17]The Income Tax Act,1961, s. 112.

[18]Kartik Hegadekatti, "Examining taxation of fiat money and bitcoins vis-à-vis regulated cryptocurrencies", *SSRN Electronic Journal*(2016).

be still answered about the regulation as well establishment of clear rules on taxation.

Thus, there is an immediate need establish a clear stand on digital currencies in India to ensure their stability and security.

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