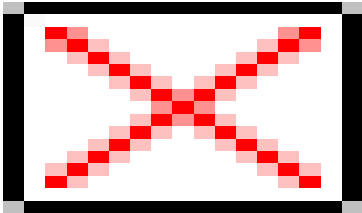


Taxation of Cryptocurrency in India - Part-I - Status quo on transaction validity

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1. INTRODUCTION

The modes and means of transaction have evolved from barter to coins stamped in precious metals to legally recognized payment currency. These legal tender currencies across the board have a governing body, usually the Central Bank of the respective sovereign territories. With the emergence of technology, there is a deviation from such traditional forms of currency. For example, Virtual Currencies ('VC') which have been brought into existence and are commonly known as Cryptocurrency.

Cryptocurrency is a digital asset created with the aid of the internet and it is not regulated by any central bank in the world. Each currency unit is unique which is owned by a person who acquires it either by mining or purchasing the already mined VC's. Primarily, a virtual currency system relies on a technology known as Blockchain.

We strive to analyze the following, in a III - Part article. Part I, will deal with the fundamentals of Blockchain and Virtual currencies, while Parts II and III, analyze the potential applicability of Income Tax Act, 1961 and GST laws in force respectively.

1.1. Blockchain

Blockchain is a technology wherein packets of data are stored in multiple un-editable copies. It operates on a system termed as Distributed Ledger Technology ('DLT') wherein each block records a specific number of transactions. Every time a participant makes a transaction, the blockchain records the same in the participant's ledger. The said ledger database is managed by multiple participants making it decentralized by nature and hence known as DLT. Certain characteristics of Blockchain are as follows:

- a. Blockchain is a programmable technology, which is based on an algorithm formula;
- b. All the participants have a copy of the DLT which is encrypted;
- c. Records are times tamped & validated. Hence, they cannot be modified and are irreversible;
- d. The identity of the participants is completely anonymous.

1.2. Blockchain and Cryptocurrency

A new block of the blockchain is mined by solving a complex math problem, wherein various combinations of nonce and hash are subjected to permutations and combinations to arrive at the end result i.e., the solution to problem. Once a new block is generated, it gets integrated to the existing chain to become a part of the same. The reward for mining such a block using the super computers is in the form of Cryptocurrency. In the present era, however, Cryptocurrency has also become a tradable commodity.

1.3. Types of cryptocurrencies vis-À-vis purpose of existence

The origin of various cryptocurrencies is by virtue of various blockchains created for specific purposes. These respective chains, reward the successful miner with their underlying cryptocurrencies. The following are the top five cryptocurrencies basis their market capitalization and popularity at the time of writing:

S. No	Cryptocurrency	Purpose of existence	Market Capitalization (USD)	Avg Growth rate (%)
1.	Bitcoin ¹	To decentralize distribution, trading, and storing currency.	USD 611,623,824,137	85.82%
2.	Ethereum ²	For processing financial transactions, execution of smart contracts, and store data for third party applications.	USD 251,609,250,663	195%
3.	Tether ³	To make trading in cryptocurrencies easier and cheaper.	USD 62,306,997,029	935.7%
4.	Binance Coin ⁴	Utility token for discounted trading and transaction fees.	USD 48,516,917,822	246.6%
5.	Cardano ⁵	To provide a balanced and sustainable ecosystem for cryptocurrencies	USD 43,703,123,511	217.1%

2. VOLATILITY OF CRYPTOCURRENCY VALUE

Similar to any precious commodity, the value of cryptocurrency is deemed to be dependent on the formula of supply and demand. The statistical probability of a miner finding a solution to create a new block has declined tremendously, since only a unique formula (never mined before) can result in the addition of a block to the chain.

However, the value of VC is also sans such theory, as the certainty in the mining process is beyond the boundaries of established economic concepts. The growth rate in the aforesaid table clearly indicates such volatility which is evident from the gigantic market capitalization of VCs. The word VC being nothing more than a **PONZI** scheme is also reverberating due this dynamic growth rate.

3. TRANSACTIONS IN VC - SUPREME COURT STRIKES DOWN BAN

3.1 RBI cautions retail investors about VCs

In India, the foray into cryptocurrency has been confusing at best. Vide Press Release dated 24.12.2013, the Reserve Bank of India ('RBI') had cautioned users, holders, and traders of the potential financial, operational, legal, and security risks associated with virtual currency. ⁶

It had outlined various cautionary statements summarized as follows:

- a. Creation, trading, or usage of VCs as a medium for payment are unauthorized by any central bank or monetary authority. Hence, they are prone to various security risks including compromise of information, hacking, loss of password, malware attacks among others.
- b. Payments through VCs occur on a peer-to-peer basis without regulation by an authorized agency where an established framework for customer disputes might be absent.
- c. VCs are not issued upon any underlying assets akin to traditional currencies which are based on Gold and Foreign exchange, among others. Further, the volatility of VCs exposes users to significant potential losses.
- d. Legal status of VCs is unclear owing to their non-jurisdictional existence.

3.2 Supreme Court strikes down RBI's ban on VCs

In April 2018, the Reserve Bank of India (RBI) banned cryptocurrency thereby making it illegal in India vide Notification No. RBI/2017-18/154 dated April 6, 2018. ⁷ This ban was challenged before the Hon'ble Supreme Court on the grounds that:

- a. RBI has no power to prohibit trading of virtual currency and hence it cannot impose the ban on the same; and
- b. The services rendered by the exchanges do not qualify to be 'payment systems' under the Payment and Settlements Act, 2007;

In a landmark judgment on March 4, 2020, the Hon'ble Supreme Court struck down the same on the ground that the ban was a hindrance to business opportunities and took away the rights under Article 19 (1) (g) of the Constitution. Further, it was held that RBI failed to prove the hazards of cryptocurrency. ⁸

Currently, a legislation has been tabled, the essence of which is the prohibition of all private cryptocurrencies in India, subject to certain exceptions i.e, cryptocurrencies regulated and controlled by the State would be recognized as a formal medium of transaction, whereas other currencies may be rendered invalid.

3.3 RBI declares circular dated 06.04.2018 as no longer valid

Vide circular DOR. AML. REC. 18/14.01.001/2021-22 dated 31.05.2021, RBI communicated that the circular DBR No. BP.BC.104/08.13.102/2017-18 dated 06.04.2018 is no longer valid in view of the Supreme Court judgment ⁹

. The circular stated that banks or regulated entities have cautioned customers against dealing in VCs which is not in order of the Supreme Court dated March 04,2020. Further, RBI stated that Banks and other regulated entities may continue to provide services to customers in the existing mechanism of overseas remittance.

4. FUTURE OF VC

At this juncture, the food for thought would be to examine cryptocurrency analogous to the Indian Rupee (INR). Envisioning the fact that VCs would be publicly bartered for goods and/or services, the transactions will be subject to tax under the current regime. Further, cryptocurrency is fundamentally intangible, which raises questions as to its definition. According to The Foreign Exchange Management Act (FEMA), among others, currency is defined to include instruments similar to currency notes, cheques, drafts, bills of exchange, promissory notes and etc., which may bring cryptocurrency within its purview¹⁰.

In the present day, the RBI circular dated May 31, 2021, if interpreted generously, can be a sign of approval for investment in VCs. RBI has not expressly announced its support towards VCs, and at the same time has not imposed curbs in respect of the same. Pursuant to the aforesaid circular, a host of platforms have started to facilitate investments in VCs.

The risk and reward for the customers have been incredibly volatile this year and it remains to be seen whether the Cryptocurrency and Regulation of Official Digital Currency Bill, 2021 would establish the necessary safeguards to protect the interest of the investors. In the alternative, the said bill could also impose restrictions to deter citizens from investing into a potentially inflammable medium and in-turn increasing the foreign outward remittances. However, various investors believe that RBI may also have an indigenously developed central bank digital currency for India.

5. TAXATION OF VC

The next question to ponder upon is the levy of tax on cryptocurrency under the present framework of Income Tax and Goods and Service Tax Law.

Whether the VC's are in the nature of securities or commodities, which would be subjected to capital gains or are the transactions in the nature of wagers and hence taxed as other sources. For the purpose of GST, whether VC's will be goods or services and accordingly, the tax liability or will they be outside the ambit of GST.

A detailed analysis of the aforesaid questions will be done in Part II and Part III of this Article.

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â€¦to be continued

¹Statistics and Indicators for 'Bitcoin', Y-charts, https://ycharts.com/indicators/bitcoin_price

²Statistics and Indicators for 'Ethereum', Y-charts, https://ycharts.com/indicators/ethereum_price

³ Statistics and Indicators for 'Tether', Y-charts, https://ycharts.com/indicators/tether_price

⁴Statistics and Indicators for 'Binance Coin', Y-charts, https://ycharts.com/indicators/binance_coin_price

⁵Statistics and Indicators for 'Cardano', Y-charts, https://ycharts.com/indicators/cardano_price

⁶RBI cautions users of Virtual Currencies against Risks, Press Release dated December 24, 2013, https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=30247

⁷ Prohibition on dealing in Virtual Currencies (VCs), Notification No. RBI/2017-18/154 dated April 6, 2018, <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11243>

⁸ Internet and Mobile Association of India vs Reserve Bank of India, MANU/SC/0264/2020, order dated 04.03.2020

⁹ Internet and Mobile Association of India vs RBI, *Ibid*.

¹⁰ Section 2 (h) of the Foreign Exchange Management Act, 1999

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