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TAXATION OF CRYPTOCURRENCIES IN INDIA

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ABSTRACT

We critically analyse the crypto currency and how tax is levied on the same in India as well as in the foreign countries. The taxation of cryptocurrencies in India has emerged as a critical and evolving area of interest for policymakers, tax authorities, and cryptocurrency users. With the growing popularity and adoption of digital currencies like Bitcoin, Ethereum, and others, understanding the tax implications has become essential for both investors and regulators. This abstract provides an overview of the current landscape of cryptocurrency taxation in India, highlighting key issues, challenges, and considerations.In India, the taxation of cryptocurrencies falls under the purview of the Income Tax Act, 1961. Cryptocurrencies are treated as assets or properties rather than currencies, subjecting transactions involving cryptocurrencies to capital gains tax regulations. The classification of cryptocurrencies as assets has significant implications for individuals and businesses engaged in buying, selling, trading, or mining cryptocurrencies. The methodology used in this research paper is the doctrinal one.

Keywords: Tax, cryptocurrency, India, authorities

I. INTRODUCTION

"Cryptocurrency" is a digital form of money created through the codes. These can also be used for sending money across the world and removing the possibility of the third-party involvement and which makes the digital currency much cheaper than standard currency. The Cryptocurrency was designed with an idea to take advantage of the internet. This new system of investment partially replaces the traditional financial intermediaries where they used to

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verify and guarantee transactions. These Cryptocurrencies and their transactions were confirmed by the users who logged into the currency's portals. Since the Cryptocurrency was protected and also encrypted, it has become difficult for the mediators to increase the standard money and also its supply based on arithmetic calculations.[3] All the users of the transactions were aware of the algorithmic rate at which the transaction had taken place. The Cryptocurrency can be produced or mined as and when required beyond any limit. The Cryptocurrency poses a very high risk to the business level and at the societal level too. The latest form of transaction is the digital money, which keeps updates of all the transactions which happens with the Block chain technology, and it ensures that the finite exchanges also happen. The transactions in Cryptocurrencies can neither be stopped nor it is can be reversed, in addition to that, it being displayed publicly is a matter concerned with security and transparency. As the concept of a virtual currency generally has included the concept of the Cryptocurrencies, which constitutes all the Cryptocurrencies like Bitcoin, and sometimes it also involves the difference between the centralized and decentralized virtual currencies which has its existence in the cloud, and it does not attain a physical form but has a digital value, and it can also be used digital equivalent to the cash which is in a steadily increasing number with the retailers and other businesses. The Pioneer among the Cryptocurrencies was the Bitcoin, which was created, and even though there is a small charge for every Cryptocurrency transaction, which is considered to be very nominal.

The Cryptocurrencies are a kind of digital token that are produced by the Cryptographic algorithms as a medium of transaction. These tokens then use the peer to peer networking system to travel through the cyberspace. The values are derived at through the demand and the supply of those tokens as it is an important part of the appeal which dwells in the devolution of the system of which they do exist. Prior to the creation of the Cryptocurrencies, there were many other types of digital currencies. These Cryptocurrencies use Crypto graphic protocols for transaction, or very complex codes that encrypt the sensitive data transfers, and also secures the units of exchange.

II. HISTORICAL BACKGROUND OF CRYPTOCURRENCY

[3] Barski, C. & C. Wilmer (2015), Bitcoin for the Befuddled, USA.

"What is needed is an electronic payment system based on Crypto graphic proof instead of trust. In the year 2009, Satoshi Nakamoto a Japanese national took the project and the idea, which eventually after working on that it helped them in publishing research paper on the currency which works on an authentic security protocol, even though that Crypto was not really a publicly known currency also. It also allows all the kinds of the transactions which occur, and in utilizing the distributed ledger is also known as the Block chain and the artificial system which permits multiple computer systems to participate in the management of these digital documents that keeps track of all the payments.[4]

Altogether, there are some 1000 Cryptocurrencies are known, but the most widespread and important one is Bitcoin. The Cryptos have a market capitalization of about 40%. They have rather replaced the centralised payment system. As there is no centralised system to monitor the availability of the digital coin, in fact banks and institutions become a spectator to the "mining process". Due to which the power held by the centralised system has weakened. The Cryptocurrencies and its liquidity cannot be therefore manipulated easily as compared to the standard traditional currency. Further going ahead on the investment patterns, an investor world finds it really difficult to do any prediction or analysis. They were purely dependent on the market analysis and the forecasting of the market prices based on the opening and closing rates. They are considered as "digital asset" which are designed through a strong Cryptography with security to face the financial transactions and to work as the medium of exchange, where the Cryptocurrency was able to attract the attention of the investors because of the unique concept and its extraordinary appreciation in the value of the investment. There are various questions raised about the basic functions and its legal definitions with respect to money. These are the decentralized digital currency which does not have an administrator who can monitor the transaction carried out, it uses the concept of peer-to-peer network, which do not require actual intermediaries11 . These digital assets and their transactions are saved through the Block chain technology for future use. These exchanges are settled through settlement claims as the transactions with the help of internet and online banking. The most famous digital money which was the pioneer in the field of Cryptocurrency was Bitcoin. The transactions carried out to buy these currencies can neither be stopped if initiated nor can be reversed, as all the

[4] Lee, D. & K. ChuEn & L. Guo & Y. Wang (2018), "Cryptocurrency: A New Investment Opportunity?", The Journal of Alternative Investments, 20(3), 16-40.

transactions take place through the Digital currency exchange where the risk associated is also too high. All the transactions must be charged differently from currency to currency.

III. FEATURES OF CRYPTOCURRENCIES

- **Easily convertible**: Cryptocurrency can be easily converted to any other forms of currency and further it can be transferred to user's accounts at a lightning speed.
- **No Centralise Authority**: Most Cryptocurrencies can be transacted without any authentication as there is no Centralised authority to monitor the transaction and can be easily converted to discrete online cash which operational throughout the world, for which no currency conversion fees is applicable.
- **Theft free:** While not 100% defenceless from theft, Cryptocurrency is generally difficult for hackers to get involved and but safe to use.
- **No physical existence**: Cryptocurrencies can be saved offline as well as in a "paper" wallet or in a external storage hard drive which can be easily disconnected from the internet whenever not in use.

IV. REGULATORY MECHANISM IN INDIA

Currently, the regulatory mechanisms to govern bitcoins are almost non-existent in India, and although bitcoins are not legal as yet, they have not been outrightly declared illegal either. Having said that, bitcoins have not entirely failed to gather the interest of policymakers. Recently, the Serious Fraud Investigations Office ('SFIO'), the investigative arm of the Ministry of Corporate Affairs, was instructed to gather data regarding the use of bitcoins by corporate entities. Introduction of a regulatory regime has almost become essential, primarily because of the rapid increase in market capitalisation of cryptocurrencies in the recent past. It has also been suggested that such currency be traded on registered stock exchanges, similar to gold, in order to establish a formal tax base, and the transactions be governed by the Securities and Exchange Board of India ('SEBI'). This is a crucial development, since the jurisdiction of SEBI in SEBI v. Pan Asia Advisors Ltd. ('Pan Asia') was held to extend to entities beyond India, according to the territorial nexus doctrine. Further, it can help the regulators in enforcing the SEBI Act and other disclosure requirements on entities operating in the bitcoin network, while regulating cryptocurrencies in India (traded globally). Moreover, considering bitcoins as security would mean that the sellers of bitcoins, exchanges where such currencies are traded and SPVs formed to hold bitcoins would be subject to stringent regulatory requirements and arduous penalties for non-compliance under the existing securities laws of India. Besides, an approach to encompass bitcoin transactions within the ambit of SEBI is similar to that adopted by the US Securities Exchange Commission ('SEC') a few years ago, where it brought an action against virtual currency related investments, citing them as 'securities'.[5]

V. BITCOINS AS SECURITIES, DERIVATIVES

There is little doubt that the perceived value of bitcoins is subject to enormous volatility as compared to traditional currency. Such price volatility may, prima facie, give an illusion that it should be governed in the same manner as securities or derivatives.

The word 'securities' has been defined in §2(h) of the Securities Contracts (Regulation) Act, 1955 ('SCRA'), to include, inter alia, shares, bonds, debentures, derivatives, government securities, and such other instruments as may be specified by the Central Government.76 One of the essential feature of securities is that they must be issued by an 'issuer' (such as a public or private company), whereas cryptocurrencies are decentralised – meaning that they are not issued by any authority. Thus, they could, at the very best, be covered within the scope of definition only if they are specified by the Central Government as such. Furthermore, a 'derivative' under the SCRA means either of the two things – (i) security derived from debt instrument, share, loan, risk instrument, contract for differences or any other form of security; or (ii) a contract which derives its value from the prices of underlying securities. Derivatives are basically securities meant to aid and assist temporary hedging of risk in the price of either inventory holding or a financial commercial transaction. There are two essential features of derivatives – (i) they do not hold any independent value i.e. the value is derived from an underlying asset and (ii) a derivative is a contract to hedge risk. Apart from this, in practice, almost all derivatives have a fixed expiry date, as the value of the contract is dependent on this expiry period. It is difficult to see these features in cryptocurrencies since (i) cryptocurrencies

[5] Narayanan, A. & J. Bonneau & E. Felten & A. Miller & S. Goldfeder (2016), Bitcoin and Cryptocurrency Technologies: A Comprehensive Introduction, Princeton University Press.

have independent value and (ii) it is not a contract per se. Moreover, it does not fit within the definition prescribed under the SCRA.

VI. ISSUES RELATED TO TAXATION AND CRYPTO CURRENCIES

1. **Classification**: The classification of cryptocurrencies for tax purposes varies across jurisdictions, leading to ambiguity and inconsistency in tax treatment. Determining whether cryptocurrencies should be treated as currencies, commodities, securities, or assets for tax purposes is a significant challenge.

2. **Valuation:** The valuation of cryptocurrencies for tax reporting purposes is often complex and subject to interpretation. The volatile nature of cryptocurrency markets makes it difficult to establish a consistent and accurate valuation method, leading to potential discrepancies in tax reporting.

3. **Reporting requirements**: Tax reporting requirements for cryptocurrency transactions are often unclear or insufficiently defined, leading to confusion among taxpayers and potential non-compliance. Taxpayers may struggle to understand their obligations regarding the reporting of cryptocurrency transactions, including trading, mining, and income generated from cryptocurrency investments.

4. **Tracking and compliance**: Due to the decentralized nature of cryptocurrencies and the pseudonymous nature of blockchain transactions, tracking cryptocurrency transactions for tax compliance purposes can be challenging for tax authorities. Ensuring compliance with tax laws and regulations regarding cryptocurrency transactions requires the development of effective tracking and monitoring mechanisms.

5. **Cross-border transactions**: Cryptocurrency transactions often involve cross-border transactions, which can complicate tax reporting and enforcement efforts. The lack of harmonization between different jurisdictions' tax laws and regulations regarding cryptocurrencies can lead to double taxation, tax evasion, and challenges in enforcing tax compliance.

6. **Regulatory uncertainty**: The lack of clear and consistent regulatory frameworks for cryptocurrencies in many jurisdictions creates uncertainty for taxpayers and tax authorities alike. Taxpayers may struggle to understand their tax obligations in the absence of clear guidance, while tax authorities may face challenges in enforcing tax laws and regulations in the rapidly evolving cryptocurrency ecosystem.

VII. TAXATION OF CRYPTOCURRENCIES

Nowadays, cryptocurrencies are the new preference of investors because tax havens have lost their popularity in tax evasion due to multilateral tax information exchange agreements. However, problems that may arise in regulations related to cryptocurrency, such as the ineffectiveness of the Tobin Tax proposal from problems experienced in the precise determination of the values of electronic payments, are not wanted to be involved in the depths of financial markets and can be evaluated in common with the problems experienced in the delivery of e-services.[6] Especially when the online presentation of some electronic services is paid out, the problems experienced in the taxation also apply to the cryptocurrencies. For example, some evidence indicates that Bitcoin is used for tax evasion purposes. According to a study on the topic; the majority of Bitcoin wallet owners use them as investment accounts. Such accounts do not send Bitcoin; it is only used to receive. The gains in such wallets are not accessible to the tax authorities unless they are expressly granted. In addition, researchers have discovered that many Bitcoin users use the cut, split and combine method. Generally, Bitcoins are divided into multiple small accounts of the same person, or large amounts are transferred in bulk using multiple wallets. Tax evaders and money launders often use these methods to hide funding sources and the destination (Melendez, 2013) As a result, the legal regulations on cryptocurrencies vary from country to country. In some countries the use and trading of cryptocurrency is illegal, and in some cases legal. Legal regulations on cryptocurrencies are taxed or excluded, depending on whether the cryptocurrency is being assessed as “currency”, “capital gains” or “commodities”. The EU explained that cryptocurrency trading should not be subject to VAT on the basis that foreign exchange transactions are a substitute for a supply of goods. This was also adopted by the UK .

[6] Norman A. (2017), “Cryptocurrency Mining”, CreateSpace Independent Publishing Platform, September 25, 2-4.

RBI Guidelines for cryptocurrencies

The Reserve Bank of India(RBI) today clarified that banks and other entities cannot cite its 2018 order on virtual currencies as it has been set aside by the Supreme Court of India in 2020. The clarification from the central bank will come as a sign of relief for all investors and crypto exchanges in India who invested in virtual currencies.

RBI in a notification said , "It has come to our attention through media reports that certain banks/ regulated entities have cautioned their customers against dealing in virtual currencies by making a reference to the RBI circular DBR.No.BP.BC.104/08.13.102/2017-18 dated April 06, 2018. Such references to the above circular by banks/ regulated entities are not in order as this circular was set aside by the Hon'ble Supreme Court on March 04, 2020 in the matter of Writ Petition (Civil) No.528 of 2018 (Internet and Mobile Association of India v. Reserve Bank of India)."

The Central Bank further added, "Banks, as well as other entities addressed above, may, however, continue to carry out customer due diligence processes in line with regulations governing standards for Know Your Customer (KYC), Anti-Money Laundering (AML), Combating of Financing of Terrorism (CFT) and obligations of regulated entities under Prevention of Money Laundering Act, (PMLA), 2002 in addition to ensuring compliance with relevant provisions under Foreign Exchange Management Act (FEMA) for overseas remittances."

The latest directive comes against the backdrop of some banks and regulated entities citing the circular and cautioning customers against dealing in virtual currencies.

The circular, issued on Monday, is addressed to all commercial and co-operative banks, payments banks, small finance banks, NBFCs and payment system providers.

Earlier, HDFC Bank and State Bank of India (SBI) have cautioned their customers against dealing in virtual currencies such as bitcoin, according to emails sent by the lenders.

Private digital currencies/ virtual currencies/ crypto currencies have gained popularity in recent years. In India, the regulators and governments have been sceptical about these currencies and are apprehensive about the associated risks, RBI had said in its Booklet on Payment Systems issued in January 2021.

VIII. SELECTED COUNTRY APPLICATIONS IN THE TAXATION OF CRYPTOCURRENCY TRANSACTIONS

Cryptocurrency transactions defined and taxed differently in many countries like Canada, USA, Germany, UK, and Australia. In June 2014, Canada is the first country in the world to establish a tax on virtual currencies. The Bank of Canada has expressed a willingness to acknowledge the developing virtual currency market, but currently recognizes cryptocurrencies as investments. In the United States, a cryptocurrency has been accepted as "asset", according to the Swedish Financial Supervisory Authority cryptocurrency is "a payment method". In the UK is treated as a special currency and VAT is applied to the purchases made with them. The Finnish Central Tax Board has exempted the Bitcoin transactions from VAT, which identified cryptocurrency as a financial service. In April 26, 2018 in France Conseil d'Etat identified the gains from cryptocurrencies as capital gains. The tax rate applied to crypto-dollar decreased from 45% to 19%. Iceland, Russia, Denmark and China are preparing lunch to the market their own cryptocurrencies . China, Thailand, Bangladesh and Bolivia limit the use of cryptocurrency. While prohibiting the use of it by enterprises in China, it is possible for individuals to own cryptocurrency, with the risk and use being on their behalf. In December 2015, the People's Bank of China prevented the cryptocurrencies transactions of financial institutions [7]

IX. CONCLUSION

Although it is an alternative currency option in terms of users is positive, it is not recommended to widely use the cryptocurrency because of the unknown risks and uncertainty of the gains and losses of bitcoins hiding for investment purposes. However, it is thought that cryptocurrency can even pass the credit card, if designed by a central institution in a highly secure manner, primarily for a sectoral pilot application and support the official currency of the country. The most basic reasons for this are the inability to process online transactions from ATMs and the possibility of trading with cryptocurrency outside official holiday or weekend break times, which will increase the preference of it. In recent days, will be held in comparison with the gold payment system in Turkey, physical money exchange gold stored in Istanbul seem to be

[7] Polasik, M. & A. Piotrowska & T.P. Wisniewski & R. Kotkowski & G. Lightfoot (2014), Price Fluctuations and the Use of Bitcoin: An Empirical Inquiry

more reliable than an investment with cryptocurrency through guarantor institutions located behind is that can be transferred in the EFT speed.

However, because of the more innovative payment system, the availability at the global level, providing the opportunities to its criminal incomes, and the opportunity to obtain high profit if it is risky to its users, cryptocurrency can substitute for other payment systems in the long run. But, cryptocurrency has been criticized for the availability of mobile wallets, the ongoing risk of user education such as inadequacy, reliability, accessibility and price change in the storage and transfer of cryptocurrency, and the low perception of users' ease of use of cryptocurrency. The necessity of using the online shopping service in most of the places and the fact that the density of use is not allowed is deepened. It is estimated that cryptocurrency ATMs have become widespread and will be an important player in the online payment market of cryptocurrency.[8]

In this context, in practice bank investment instruments, credit card payments, cash, cryptocurrency can be compared. While the Bank pays interest payments to the investment vehicles, the deposit is subject to such interruptions as the insured amount, there is no interest payment in the cryptocurrency. Although the high amount of cash transfer is quite costly and difficult, the risk of taxation in the long run of crypt money, which is easy to use in high amount of money transfer, is fast and cheap. Cryptocurrency is considered unavailable for the purpose of hiding value due to price fluctuations. While it is advisable not to control money supply, it can be criticized for being banned by governments.

Besides, the development of crypto coin and blockchain encryption technology will enable many new technologies to be achieved in the future. However, the various technological business opportunities created by the cryptocurrency industry are also remarkable. These include web development expertise, web security system design, market research analyst, marketing manager, financial analyst, and data scientist, business development representative and mining. For example, the most known "mining" in the mentioned works is getting harder day by day due to the difficulties that are expected to be solved and as a result the money earned in the sector is falling. The cost of crypto coin production is high if the cost is not available in countries offering low electricity. Since the cryptocurrency mining has caused the

[8] Renterghem, J.V. & W.D. Meerleer (2017), "From Bits to Coins: Price Formation of Bitcoin", Aantal Woorden: 21479, Master Thesis

investment, maintenance and high level of energy consumption required by expertise, the residence of miners is more concentrated in China and Russia. But, Russia plans to rent cheaper apartments and transfer investors to the industrial zones by making cryptocurrency mining. It is also on the agenda to sell cryptocurrency miners electricity at different prices.

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[11] Jochen Kasper, (2017) Evolution of Bitcoin: Volatility Comparisons with Least Developed Countries Currencies” Journal if Internet Banking and Commerce, on Dec 2017, Pp 1-22.