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THE DIGITAL ERA: CRYPTOCURRENCY AND ITS (IN)EFFICIENT TAXATION AND REGULATION POLICY

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THE DIGITAL ERA: CRYPTOCURRENCY AND ITS (IN)EFFICIENT TAXATION AND REGULATION POLICY

Kumar Rishav[*] & Divya Venugopalan[**]

[***Abstract***: *Cryptocurrency, recorded publicly in blockchain and characterized by its reliance on encryption algorithms, has emerged as a disruptive force in the financial landscape, providing an alternative to conventional payment systems. Its autonomous operating capability, which is considered one of its greatest advantages, cryptocurrencies function as both a medium of exchange and a virtual accounting system, secured by encryption technologies. Despite their decentralized nature, recent governmental interventions, particularly through the Prevention of Money Laundering Act, 2002 (PMLA) and evolving taxation policies, aim to bring regulatory oversight to the cryptocurrency realm. This paper extensively explores the operational dynamics and significance of cryptocurrencies, emphasizing on the regulatory framework governing them in India. It delves into the advantages and disadvantages of these digital assets, highlighting the regulatory and taxation gaps that contribute to illicit activities. The primary focus of the study is on the regulatory framework and direct tax policies governing Virtual Digital Assets (VDAs) post the Finance Act, 2022. The analysis delves into the current structure of direct taxation, emphasizing deficiencies within the existing framework, and proposes strategic recommendations for improvement. By dissecting the taxation intricacies associated with cryptocurrencies, this article aims to contribute to the ongoing discourse surrounding the fortification of regulatory frameworks in the dynamic and rapidly evolving landscape of digital finance. It is thus imperative, that India not only recognize cryptocurrency as legal tender but also implement a policy for indirect taxation and improve the direct tax policies regulating virtual digital assets*.**]**

Keywords: Cryptocurrency, Capital gains, PMLA, Taxation, Virtual digital assets.

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I

Introduction

"Modern technology has become a total phenomenon for civilization, the defining force of a new social order in which efficiency is no longer an option but a necessity imposed on all human activity."[1]

From the first cryptocurrency being obscurely introduced to the world in 2009 as a piece of code, to the evolution and recognition of cryptocurrencies by numerous countries – the world of virtual currencies has risen to emerge as the most sought-after investment and medium of exchange.

Cryptocurrencies are virtual digital assets recorded on decentralized, public ledgers. These ledgers, better known as blockchain, serve as records of asset ownership and transfers. Cryptocurrencies are digital currencies relying on a peer-to-peer network which operates without the need for a third-party intermediary like central banking authority. In the words of Satoshi Nakamoto, the pseudonymous founder of Bitcoin, cryptocurrencies are based on an "electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party."[2]

In the Indian context, the Income Tax Act, 1961 defines cryptocurrency along the same lines, as a "virtual digital asset" as *"any information or code or number or token (not being Indian currency or foreign currency), generated through cryptographic means or otherwise, by whatever name called, providing a digital representation of value exchanged with or without consideration, with the promise or representation of having inherent value, or functions as a store of value or a unit of account including its use in any financial transaction or investment, but not limited to investment scheme; and can be transferred, stored or traded electronically."*[3]

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[1] Jacques Ellul, *The Search for Ethics in a Technicist Society*, INTERNATIONAL JACQUES ELLUL SOCIETY (1983) *available at* https://ellul.org/themes/ellul-and-technique/ (last visited 15 Feb. 2023)

[2] Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System available at*: https://bitcoin.org/en/ (last visited 1 Mar. 2023).

[3] The Income Tax Act, 1961, S. 2(47A) (a).

The lack of clear taxation policies and regulatory frameworks and taxation policy for cryptocurrencies in India has created a challenging environment for investors, users and government, leading to confusion and uncertainty. The problem arises when an asset is sold and capital gains tax is imposed, some benefits are provided to the taxpayers such as set-offs[4] and taxes are supposed be levied on the Fair market value of the asset but because of the nature of cryptocurrency the fair market value is difficult to be determined and in several cases it is not possible to know the accurate gains which might lead to wrong levying of taxes and will create disputes between revenue and taxpayer.

This paper aims to investigate the current regulatory mechanisms and income tax aspects of crypto currencies after the Finance Act, 2022, which included cryptocurrencies (though not directly) under the definition of Virtual digital asset under section 2(47)(A) of the Income Tax Act, 1961 and will tax it as capital gains under section 45 of the Income Tax Act, 1961[5] on the sale of any such asset. This paper also seeks to analyse the concerns regarding this tax policy which does not provide several benefits to taxpayers and also remains ambiguous on various points which makes the implementation onerous.

The paper undertakes a doctrinal methodology by relying on both primary and secondary sources of data. The predominant primary sources are taxation legislations and precedents involving the interface of taxation and virtual assets. Qualitative data is collected using the grounded theory of research and a combination of thematic and textual analysis is undertaken for analyzing the collected data. The aforementioned approaches to data collection and analysis are used owing to the nature of the study, which involves in-depth scrutiny of specific taxation laws and Supreme Court judgments and highlighting the contradictions between them by examining their content and patterns of application. Currently, the Income Tax Act of 1961 treats cryptocurrencies, NFTs (Non-Fungible Tokens), and other Virtual Digital Assets (VDAs) in a uniform manner. This is because all of these digital assets share the same fundamental structure, which is the 'blockchain'. As a result, this paper uses the terms 'VDAs' and

[4] *Id.* S. 35AD.

[5] *Id.* S. 45.

'Cryptocurrencies' interchangeably, implying that tax regulations applicable to one can also be extended to the other.

II

Background of Cryptocurrency in India

Essentially, the two most distinguishing characteristics of cryptocurrencies in general are the absence of third-party intervention and decentralization. In addition to this, yet another factor that distinguishes cryptocurrencies from other digital assets is that they are convertible to legal tender on a cryptocurrency exchange. Anonymity, transparency, control, security and low transaction costs are few of the numerous advantages of digital currencies.[6] Nevertheless, they are riddled with the impediments of risk and volatility, tax evasion and illegal activities.[7]

Cryptocurrencies function through the distributed ledger technology[8], a large, decentralized database that is maintained on a network of computers rather than a single server, and that is updated in real-time. Further, a blockchain is a cryptographically-secured digital ledger, and its protocol is the software that governs rules, operations, and communications between computers interacting with the blockchain.[9]

Users can obtain or "mine" cryptocurrencies by verifying the blockchain identity of, say Bitcoins, used in an online transaction, acquire them as gifts or as payment for goods and services from other users, or just purchase them on third-party exchanges.[10] The blockchain grows from the interaction between users, miners and nodes. Users contribute transactions by broadcasting them to nodes. To create a block to add to the blockchain, miners compete to solve a

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[6] Nicholas A. Plassaras, *Regulating Digital Currencies: Bringing Bitcoin within the Reach of the IMF*, 14 CHI. J. INT'L L. 378 (2013).

[7] Institute for Development and Research in Banking Technology, *White Paper on Applications of blockchain technology to banking and financial sector in India, available at*: https://www.idrbt.ac.in/wp-content/uploads/2022/07/BCT.pdf (last visited 2 Mar. 2023).

[8] Hilary J. Allen, *$=6=Bitcoin?*, 76 MD. L. REV. 877, 886 (2017).

[9] Carla L. Reyes, *Conceptualizing Cryptolaw*, 96 NEB. L. REV. 384, 391 (2017).

[10] Joshua J. Doguet, *The Nature of the Form: Legal and Regulatory Issues Surrounding the Bitcoin Digital Currency System*, 73 LA. L. REV. 1119 (2013).

cryptographic mathematic puzzle, called a "proof of work", in order to collect a reward in bitcoins.[11]

Owning cryptocurrency involves having a private key. This key, when matched with the public blockchain, allows owners to access their cryptocurrency and transfer it to another person. A transfer occurs when it is recorded on the blockchain. Since the blockchain is maintained through a decentralized process, once a transaction is recorded on the blockchain, it is virtually impossible to reverse.[12] This acutely prevents the problem of "double-spending", whereby the same cryptocurrency is transferred twice.

All digital transfers of money suffer from potential double-spending because it is virtually costless to copy and reproduce digital files and data.[13] One role played by financial institutions is that they take on the role of third-party watchers over transactions taking place to help create trust in the eyes of users of digital money, who can be reassured money is not being misappropriated or spent twice. The blockchain plays a role similar to the one played by third-party financial institutions that maintain ledgers of transactions, except, it is done on a publicly verifiable ledger that everyone can access, thereby making the institution redundant and increasing cooperative efficiency.[14]

The technological advance of Bitcoin is its ability to process transactions over a distributed network without a central node functioning as a monetary authority. Presently, processing transactions using the blockchain are less costly than the traditional approach. Moreover, the business of processing transactions tends to be highly concentrated. As such, the volume of transactions handled by each payment processor means that the benefit of switching might be quite large, and the small number of participants means that the cost of

[11] Georgios Konstantopoulos, *Understanding Blockchain Fundamentals, Part 2: Proof of Work & Proof of Stake*, MEDIUM (Dec 8, 2017) *available at*- https://medium.com/loom-network/understanding-blockchain-fundamentals-part-2-proof-of-work-proof-of-stake (last visited 4 Mar. 2023).

[12] Malavika Nair & Daniel Sutter, *The Blockchain and Increasing Cooperative Efficacy*, 22 INDEP. REV. 529 (2018).

[13] International Monetary Fund, *Virtual Currencies and Beyond: Initial Considerations available at* https://www.imf.org/external/pubs/ft/sdn/2016/sdn1603.pdf (last visited 28 Feb. 2023).

[14] *Supra* note 12, Nair and Sutter.

coordinating to overcome network effects are probably small. Hence, to the extent that the blockchain technology lowers transaction costs, it will increasingly be adopted to process digital payment.[15]

Further, supporters of cryptocurrency argue that the blockchain technology serves as a substitute for trust. This suggests that when conducting a transaction on the blockchain, trust is shifted from a traditional trusted intermediary, such as a bank, to the blockchain system itself. In such transactions, the parties involved rely on the blockchain to perform the functions that a bank would in a typical transaction, including facilitating the transfer, verifying the authenticity of the sender, and guaranteeing the legitimacy of the exchanged currency. The blockchain purports to do this via cryptography and a consensus mechanism which provides a guarantee that transactions are valid.[16] What attracted people to Satoshi's Bitcoin, was the fact that while Central Banks had no restraints in unlimited printing of money, thereby devaluing all savings and holdings, the Bitcoin software had rules to ensure that the process of creating new coins would stop after 21 million were out in the world.[17]

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[15] *Supra* note 6, Plassaras.

[16] Rebecca M. Bratspies, *Cryptocurrency and the Myth of the Trustless Transaction*, 25 MICH. TECHNOL. LAW REV. 1 (2018).

[17] *Internet and Mobile Association of India* v. *Reserve Bank of India*, (2020) 10 S.C.C. 274.

III
Economic Implications of Cryptocurrency

Blockchain technology has emerged alongside various cryptocurrencies and in tandem with numerous advancements in online social collaboration, including smartphone apps and social media. These technological breakthroughs pose challenges to our traditional economic understanding. We are currently witnessing a remarkable surge in the effectiveness of cooperative efforts, where people can better address issues related to social cooperation through voluntary mechanisms. The distributed ledger aspect of the blockchain plays a significant role in this innovation. While the specific effects on cooperative efficiency are still being studied, it is clear that these innovations are occurring simultaneously. However, an increase in cooperative efficiency, all else being equal, makes voluntary approaches to providing public services and regulation more appealing when compared to government provision.

Cryptocurrencies offer Bitcoin offers substantial economic advantages compared to conventional currencies and payment systems. It brings about numerous economic benefits, such as lowering transaction expenses, potentially enhancing the speed at which money circulates, enabling microtransactions, and extending access to banking services for individuals in less developed regions who might otherwise be excluded. Transactions that are computationally impractical to reverse would protect sellers from fraud, and routine escrow mechanisms could easily be implemented to protect buyers.[18] Moreover, the growth of currencies like Bitcoin has tremendous benefits in making banking accessible to marginalized population without a need for third-party intervention.[19] Thus, costless transactions at near lightning speed using open-source, independent and unalterable currency such as virtual

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[18] Jerry Brito & Andrea Castillo, BITCOIN: A PRIMER FOR POLICYMAKERS 29 (4th ed., 2013).

[19] Brett Scott, *How Can Cryptocurrency and Blockchain Technology Play a Role in Building Social and Solidarity Finance?* 5-13 (United Nations Research Institute for Social Development Working Paper Group, Paper No. 2016-1, 2016) *available at* https://www.unrisd.org/en/library/publications/how-can-cryptocurrency-and-blockchain-technology-play-a-role-in-building-social-and-solidarity-finan (last visited 5 March, 2023).

currency opens the door to an unknowable amount of future innovation.[20]

Bitcoin is a digital currency created by software developers, designed to mimic a finite resource with a predetermined production rate. Its value is based on the trust of its users and is safeguarded by its limited supply and the cryptographic security that authenticates the currency. However, it has been and continues to be utilized for the illicit purchase of substances and in the commission of unlawful activities. Since cryptocurrencies like Bitcoin are not issued or regulated by a central authority or government, their use presents various unexplored legal and other risks. Nevertheless, despite these challenges, they offer substantial economic advantages when compared to traditional online currencies and transaction methods. As a result, governments should further delve into virtual currencies and regulate businesses that exchange in crypto, but without attempting to stop or slow the growth of the currency itself and without attacking otherwise law-abiding citizens who transact in virtually.[21]

The February 2019 Subhash Chandra Garg Committee Report recommended against allowing private cryptocurrencies. The Department of Economic Affairs, Ministry of Finance, constituted the Subhash Chandra Garg Committee to suggest specific actions to be taken in connection to virtual currencies. According to the Committee, these cryptocurrencies cannot serve the function of a currency. Since they conflict with the fundamental goals of money and currency, private cryptocurrencies cannot take the place of fiat currencies. The Committee further suggested that all privately traded cryptocurrencies, with the exception of any issued by the government, be prohibited in India. The Committee also suggested that a group be constituted to study and build a suitable digital currency concept that would fit the Indian setting. The Committee further stipulated that the Reserve Bank of India should act as the regulating body if it were to be decided in the future to grant the status of legal tender to digital currencies. The Committee also gave a model Bill titled as "Banning of

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[20] *Supra,* note 16, Rebecca M. Bratspies.

[21] Jonathan B. Turpin, *Bitcoin: The Economic Case for a Global, Virtual Currency Operating in an Unexplored Legal Framework*, 21 INDIANA J. GLOB. LEG. STUD. 335 (2014).

Cryptocurrency & Regulation of Official Digital Currency Bill, 2019". As the title suggests, this Bill proposes to put a ban on the mining, generation, holding, selling, dealing in, issuing of, and transferring of, disposing of or use of cryptocurrency. The bill's provisions would make these actions criminal offenses. Additionally, subject to Central Government approval, this Bill permits government-authorized cryptocurrencies to function as legal tender and currencies.[22]

As of now, dealing in cryptocurrencies in India is not subject to any regulations in the traditional sense. The regulatory bodies have, meanwhile, cautioned users and traders about potential hazards. Further, the Reserve Bank of India has issued a number of circulars that forbid banks from transacting in cryptocurrencies. On 5-4-2018, RBI issued a "Statement on Developmental and Regulatory Policies" which directed the banks and other 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. Following this, RBI also issued a Circular dated 6-4-2018, in exercise of the powers conferred by Section 35-A[23] read with Section 36(1)(a)[24] and Section 56 of the Banking Regulation Act, 1949[25] and Sections 45-JA[26] and 45-L of the Reserve Bank of India Act, 1934[27] and Section 10(2)[28] read with Section 18 of the Payment and Settlement Systems Act, 2007,[29] directing the entities regulated by RBI (i) not to deal in virtual currencies nor to provide services for facilitating any person or entity in dealing with or settling virtual currencies; and (ii) to exit the relationship with such persons or entities, if they were already providing such services to

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[22] Vaibhav Garg, *Taxation of Cryptocurrency in India*, 2022 S.C.C. OnLine Blog OpEd 7 (21 Jan. 2022) *available at* - https://www.scconline.com/blog/post/2022/01/21/taxation-of-cryptocurrency-in-india/ (last visited 25 Feb. 2023).

[23] The Banking Regulation Act, 1949, S. 35-A.

[24] *Id.* S. 36(1)(a).

[25] *Id.* S. 56.

[26] The Reserve Bank of India Act, 1934, S. 45-JA.

[27] *Id.* S. 45-L.

[28] The Payment and Settlement Systems Act, 2007, S. 10(2).

[29] *Id.* S. 18.

them. This circular was challenged in *Internet and Mobile Assn.*[30], wherein the Supreme Court quashed RBI's circular banning the dealings in cryptocurrency. The Court stated that it is not possible for us to hold that the impugned measure is proportionate when the consistent position of RBI is that they have not banned virtual currencies (VCs) and when the Government of India is unable to make a decision despite several committees coming up with several proposals, including two draft Bills that advocated completely opposite positions. Accordingly, the circular prohibiting the entities from dealing in cryptocurrencies was overturned.

IV
Regulation of Cryptocurrency under PMLA

The government included cryptocurrency under the purview of Prevention of Money Laundering Act, 2002 (PMLA). In essence, this places it in the same category as illegal weapons, gambling, terrorism, and drugs, among other illegal actions. The intriguing thing about the Money-Laundering Act is that even though the illegal act might be covered by a different piece of legislation, an investigation might also encompass the strict, non-bailable, and mandatory PMLA. The inclusion of cryptocurrencies is commendable, but it remains to be seen how effectively the preventive steps envisioned by the PMLA Act will serve to discourage cryptocurrency trading. There is a rationale behind the PMLA's recent crackdown. The PMLA is a special piece of legislation that calls for varying degrees of punishment for both the offender and any accomplices to the crime. We refer to those who have used criminal proceeds either knowingly or unknowingly when we talk about different degrees. According to the way Section 3 of the PMLA is worded, "whoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party..."[31]The investigative agencies have a broad scope to find and seize the proceeds of crime. The counterfeit luxury products, which flood the market. If a person is directly or indirectly dealing with a counterfeit product, the proceeds of which are being used for the "scheduled offenses" of the PMLA, is

[30] *Internet and Mobile Assn. of India* v. *Reserve Bank of India*, (2020) 10 S.C.C. 274.
[31] The Prevention of Money Laundering Act, 2002, S. 3.

an accessory to the crime and their purchase, however legitimate their income may be, could be attached.[32]

PMLA is an investigation equivalent of the blindfolded lady of justice with a sword and a balance. It does have a lacunae associated with it, though. In the same section, section 3 of the PMLA, it is stated that "... proceeds of crime, including its concealment, possession, acquisition, or use, and projecting or claiming it as untainted property."[33] This is exactly the region where mapping of the crypto would be challenging. Understanding cryptocurrency requires looking at the "consideration" element of a deal. It is fiat or money in the real world, but it is an underpinning code in the realm of cryptocurrencies. The PMLA has essentially set siege to the barriers enclosing the cryptocurrency world, despite its complexity in interpretation, the identity of the owner, and the transactions inherent lack of traceability. A crypto world cannot exist in isolation and must interact with real fiat/currency as a means of exchange. This is where the PMLA enters the picture and turns the conversion of fiat into a cryptocurrency into a tainted transaction and consequently a tainted asset. The surgical strike on the cryptocurrency, however, might not always have a deterrent effect.

The Reserve Bank of India has long maintained that cryptocurrencies endanger national security and sovereignty. However, RBI has also acknowledged the potential of blockchain in a white paper issued by the Institute for Development and Research in Banking Technology ('IDRBT').[34] It stated:*"The 'blockchain' has a potential to fight counterfeiting and bring a huge revolution in the functioning of financial markets, collateral identification as well as payments systems. The technology functions on the basis of a shared and secured public ledger system and is not operated by any*

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[32] Srikant Parthasarathy & Amirthalakshmi R., *PMLA – Crypto Currency: When Prevention is Better than Cure*, 2023 S.C.C. OnLine Blog Exp 26 (Mar. 30, 2023) *available at* - https://www.scconline.com/blog/post/2023/03/15/pmla-crypto-currency-when-prevention-is-better-than-cure/ (last visited Mar. 20, 2023).

[33] The Prevention of Money Laundering Act, 2002, S. 3.

[34] Institute for Development and Research in Banking Technology, *White Paper on Applications of Blockchain Technology to Banking*, January, 2017 *available at* http://www.idrbt.ac.in/assets/publications/Best%`20Practices/BCT.pdf (last visited 5 March, 2023).

central user. Instead, it is maintained by all the participants in the system on a collective basis as per generally agreed and applied rules."[35]

V

Taxation of Cryptocurrencies

The power to levy taxes is prescribed under Article 246 which grants power to the Parliament as well as state legislatures to impose taxes.[36] Article 265 provides that no tax can be imposed or collected without the authority of law.[37] By virtue of Constitution (One Hundred and First Amendment) Act, 2016, the Parliament made several amendments with respect to the imposition of Goods and Services Tax ('GST') including Article 246A, wherein exclusive power was given to the Parliament to make laws with regard to interstate trade and commerce.[38] Furthermore, Schedule VII lists the subject matters where Parliament and state legislatures can impose taxes.[39]

Generally speaking, any bitcoin transaction may be examined from the perspectives of income and expenditure. Depending upon the nature and parties to the transaction, it may be taxable under the Income Tax Act, 1961 ('ITA') (in case of income), or Goods and Services Tax Act, 2017 ('Act') and other laws (in case of expenditure). The Finance Act 2022 introduced incidence of tax on 'Virtual digital assets'[40], which will be taxed as capital gains at 30%.
The Income Tax Act, 1961 makes no distinction between income obtained from a legal source or an illegal source and thus, both the incomes are taxable alike. However, taxation of an illegal income does not absolve the assessee of the criminal liability.[41] But as far as the case of cryptocurrency is concerned, it is still a gray area whether it is an illegal activity or not, thus in order to avoid the non-taxability of income from such transactions, the tax liability shall be imposed on the transactions in cryptocurrency.

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[35] *Id.*
[36] INDIA CONST. art. 245 cl. 1.
[37] INDIA CONST. art. 265.
[38] INDIA CONST. art. 264 cl. A (2).
[39] *See id.*, Schedule VII, List I, Union List, Items 82-92B; *See also id.*, Schedule VII, List II, State List, Items 46-62.
[40] Income Tax Act, 1961, S. 2(47A).
[41] *Mann* v. *Nash*, [1932] 1 K.B. 752.

The Income Tax Act, 1961, under Section 14 lays down heads of income as follows: [42]

1. income from salary;
2. income from house property;
3. profits and gains of business or profession;
4. capital gains; and
5. income from other sources.

Income from cryptocurrencies can broadly be said to fall either under the head of profits and gains of business or profession, under income from capital gains or under income from other sources, in case of gifts.

VI
Taxability of Cryptocurrency (Virtual Digital Assets) till 31.3.2022

Though Budget 2022 from April 1, 2022, inserted Section 115BBH[43] relating to taxation of virtual digital assets, an era of taxation of VDA in express terms has been flagged off, one may wonder what the position till then was. Virtual Digital Assets were held, traded, exchanged by people. The inclusive definition of 'income' appearing in clause (24) of Section 2[44] The Act brings under its sweep all sorts of income. Even illegal income is also subject to tax.

Therefore, though express provisions were absent, tax payers were adopting different approaches for taxation, depending on the character of Virtual Digital Asset in their respective hands. Income was considered to be taxable under the head 'Income from business and profession'[45], where VDA was held as a business commodity or from 'Capital Gains'[46] if held as a capital asset. The revenue was classified as "Business income" if the taxpayer trades cryptocurrencies as a stock-in-trade and the trade volume and frequency reflect the same. The residual head of income, "Income from Other Sources' ', discovered reporting of income from transactions in VDA in the case of errant transactions in VDA. Since there was no specific tax rate that applied to VDA income, it was taxed at the tax payer's regular slab rates, whether

[42] The Income Tax Act, 1961, S. 14.
[43] *Id.* S. 115BBH.
[44] *Id.* S. 2(24).
[45] *Id.* S. 28.
[46] *Id.* S. 45.

it was at a rate for capital gains or not. Thus, if the assessee held the VDA as investment, then depending on the holding period of the capital asset, the gain may be classified as Long-term (more than 36 months) or Short-term (up to 36 months or lower). Long term gains are subject to tax at 20% and the indexation benefit is available. Short term gains are taxable at normal applicable slab rates of the taxpayer. [47]

VII

Analysis of Taxation of Cryptocurrency as capital gains and PGBP

The definition of capital assets includes "property of any kind held by a taxpayer", with a broad understanding of "property" to cover a wide range of interests. This interpretation may encompass Virtual Digital Assets (VDAs). Therefore, the rules for Capital Gains Tax (CGT) specified in Section 45 are relevant, when VDAs are held as assets. As per Section 2(14) of the Income Tax Act, 1961[48] "capital asset" is property of any kind held by an assessee, whether or not connected with his business or profession. In *J.K. Trust v. CIT*, [49] it was held that as there is no definition of the word "property" in the Act (Income Tax Act, 1961), and that "property" must be construed in its plain natural meaning subject to the context in which that expression occurs. Further, in *Rustom Cavasjee Cooper v. Union of India*,[50] the Supreme Court observed that:

> *"38…Generally, the term "property" refers to the highest level of entitlement that an individual can have to something. This entitlement is independent of anyone else's permission and can apply to various things such as land, possessions, trademarks, copyrights, patents, and even personal rights that can be transferred or passed on, like debts. Property also implies a beneficial right to something that is considered to have monetary value, particularly in terms of transfer or inheritance, and the potential for harm to that value."*[51]

The term "property", as it appears in Section 2(14), covers within its sweep many kinds of properties. It is of such wide amplitude so as to

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[47] *Id.*
[48] *Id.* S. 2(14).
[49] *J.K. Trust* v. *CIT*, 1952 S.C.C. OnLine Bom 96.
[50] *Rustom Cavasjee Cooper* v. *Union of India*, (1970) 1 S.C.C. 248, 282.
[51] *Rustom Cavasjee Cooper* v. *Union of India*, (1970) 1 S.C.C. 248, 282.

take in both tangible as well as intangible assets.[52] The phrase "property of any kind" used in Section 2(14) is of widest amplitude and includes not only intangible assets but also intangible rights. It may either be corporeal or incorporeal.[53] In *Ahmed G.H. Ariff v. CWT* [54] the Supreme Court observed that property is a term of widest import subject to any limitation which the context may require. It signifies every possible interest which a person can hold and enjoy. The word "property" does not mean merely physical property, but also means the right, title or interest in it.[55] The all-inclusive definition of the term "capital asset" brings within its ambit property of any kind held by the assessee, except that has been expressly excluded by sub-clauses (i) to (vi) of Section 2(14) of the Income Tax Act thereunder. Thus, the expression "capital asset" has a wide connotation.[56] Therefore, cryptocurrency can be well covered within the meaning of property in definition of "capital asset" owing to the wide connotation of the expression. Property has been held to encompass intangible as well as incorporeal assets. Cryptocurrency is a form of payment that uses cryptography to control its creation and management, rather than relying on central authorities.[57] According to Nakamoto, bitcoin (a form of cryptocurrency) is a software-based online payment system and introduced as open-source software in 2009.[58] Thus, it could be concluded that the cryptocurrency is an intangible asset and thus, could be covered under the ambit of the term "property" and hence, capital asset for the purpose of Income Tax Act.

Also, in *Tata Consultancy Services v. State of A.P.*,[59] it has been held that:

> *"Software can be considered intellectual property, but the personal intellectual property contained within it can be bought and sold. This is a valuable article. The product is available in multiple formats, such as floppies, disks, CD-ROMs, punch cards, and magnetic tapes. Every individual medium that contains the intellectual property can be sold as a valuable commodity. They are perceptible. While*

[52] *Haji Abdul Kader Sahib* v. *CIT*, 1959 S.C.C. OnLine Ker 62.
[53] *CIT* v. *National Insurance Co. Ltd.*, 1977 S.C.C. OnLine Cal 314.
[54] *Ahmed G.H. Ariff* v. *CWT*, (1969) 2 S.C.C. 471.
[55] *CIT* v. *Daksha Ramanlal*, 1992 S.C.C. OnLine Guj 268.
[56] *PNB Finance Ltd.* v. *CIT*, 2001 S.C.C. OnLine Del 465.
[57] *Supra* note 17, Brito and Castillo.
[58] *Supra* note 2, Nakamoto.
[59] *Tata Consultancy Services* v. *State of A.P.*, (2005) 1 S.C.C. 308, 341-342.

mediums can facilitate the transfer of intellectual property, when it comes to assessing the tax liability under a fiscal statute, it may not be a significant factor….."[60]

"There is no disagreement that when a program is developed, it is essential to encode it, upload it, and then unload it. As observed by my knowledgeable colleague, Justice Variava, Indian law does not differentiate between tangible property and intangible property. A "goods" can refer to either a physical property or an abstract one. In order for something to be considered a good, it must possess certain properties, including: (a) usefulness, meaning it serves a practical purpose; (b) the ability to be purchased and sold; and (c) the ability to be conveyed, transferred, delivered, stored, and possessed. If a software, whether customized or non-customized, meets these characteristics, it would be considered as goods. In contrast to the American courts, the Supreme Court of India has refrained from examining the issue of severability."[61]

Hence, employing the same line of reasoning, it can be argued that cryptocurrency can be adequately encompassed under the meaning of the term "property" as it occurs in the definition of a capital asset and is therefore taxable under the Income Tax Act of 1961.

The primary issue regarding whether income should be categorized as capital gains or business profits pertains to how the asset has been managed. In other words, if the asset is regarded as an "investment" or a "capital asset", it will be subject to taxation under the capital gains category. On the other hand, if the asset is treated as "stock in trade", it will be subject to taxation under the profits and gains of a business or profession category. At this juncture, it is pertinent to note the difference between investment and stock-in-trade. In *Nawn Estates (P) Ltd. v. CIT,*[62] the Court held that the word "investment" must be construed in the ordinary popular sense of the word as used by businessmen and not as a term of art having a defined or technical meaning. Investment in general would be spending money for the

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[60] *Id.*

[61] *Id.*

[62] *Nawn Estates (P) Ltd.* v. *CIT*, (1977) 1 S.C.C. 7.

purpose of acquiring property or commodities that in turn generate further income.[63]

Hidaytullah, J.[64] had observed that the word "investment" is a word of large import. In one sense, every mode of application of one's money intended to yield a return by way of interest, income or profit is investment. While stock-in-trade includes all those goods or commodities which are dealt in the sense of buying and selling in the course of business activity, but it cannot be said to include a commodity which is acquired for the purpose of being let to hire.[65] In *M.K. Bros. (P) Ltd. v. CIT*,[66] the Supreme Court had held that the nature of the transaction depends upon the purpose for which the payment has been made and the expenditure incurred. Similarly, there might be situations where a taxpayer acquires an asset not with the intention of selling it for a profit but to keep it as a personal investment. In such cases, any profit or gain from the eventual sale or transfer of such an investment would be considered a capital gain and cannot be subject to taxation under the category of "income from business or profession". However, if the same taxpayer, who holds certain investments, later decides to convert these investments into stock-in-trade and conducts business activities with them as part of their regular business operations, any profit or gain resulting from the sale of these assets in the ordinary course of business would be considered income subject to taxation under the "profits and gains of business or profession" category. The fact that the asset concerned was originally acquired without the idea of making profit on sale, is immaterial for the purpose of assessment.[67] The law is settled that in order to determine that the asset is a capital asset or forms a part of stock-in-trade intention is the factor to be considered.[68]

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[63] *Bhai Jaspal Singh* v. *CCT*, (2011) 1 S.C.C. 39.
[64] *CIT* v. *Calcutta National Bank Ltd.*, 1959 Supp. (2) S.C.R. 6609.
[65] *H. Mohmed & Co.* v. *CIT*, 1973 S.C.C. OnLine Guj 96.
[66] *M.K. Bros. (P) Ltd. v. CIT*, (1973) 3 S.C.C. 30.
[67] *Id*.
[68] *G. Venkataswami Naidu & Co.* v. *CIT*, 1959 Supp (2) S.C.R. 6609.

Upon a perusal of the decisions[69], it is evident that the question whether an asset is a capital asset or a stock in trade depends on the intention and purpose of assessee in purchasing or acquiring that asset. It is to be noted that there is no straitjacket formula or test to determine intention - it has to be gathered from the facts and circumstances of the case. Mere holding of property or investment cannot amount to a business.[70] A person who merely invests in shares for the purpose of earning dividends does not carry on business. Although, he may, at any time, convert those shares into his stock-in-trade and carry on business in that commodity.[71] The surplus realized on the sale of shares, would be capital if the assessee is an ordinary investor realizing his holding; but it would be revenue, if he deals with them as an adventure in the nature of trade. Merely having the initial intention to sell an asset for a higher price in the future is not sufficient by itself to indicate a trading activity. It is when this intention is considered alongside the taxpayer's behavior and other surrounding circumstances that it may suggest a commercial or trading nature of the transaction. For example, an individual might invest in shares with the intent to sell them at a higher price in the future, but such an investment, even though driven by the potential for increased value, does not automatically classify it as a business or trade transaction. The test often applied is, has the assessee made his shares and securities the stock-in-trade of a business?[72]

In *CIT v. Sutlej Cotton Mills Supply Agency Ltd.*[73] , it has been held that a single transaction of purchase and sale outside the assessee's line of business may constitute an adventure in the nature of trade. Neither repetition nor continuity of similar transactions is necessary to constitute a transaction an adventure in the nature of trade. Further, it was also held that the question to be determined in such cases is that the sum of gain that has been made a mere enhancement of value by

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[69] *CIT* v. *Madan Gopal Radhey Lal*, A.I.R. 1969 SC 840; *Saswad Mali Sugar Factory Ltd.* v. *CIT*, 1999 S.C.C. OnLine Bom 948; *Dalmia Cement Ltd*. v. *CIT*, (1976) 4 S.C.C. 614; *Ramnarain Sons (P) Ltd.* v. *CIT*, A.I.R. 1961 SC 1141.

[70] *East India Prospecting Syndicate* v. *Commr. of Excess Profits Tax*, 1949 S.C.C. OnLine Cal 40.

[71] *Bengal and Assam Investors Ltd.* v. *CIT*, A.I.R. 1966 SC 1514.

[72] *Raja Bahadur Kamakhya Narain Singh* v. *CIT*, (1969) 3 S.C.C. 791.

[73] *CIT* v. *Sutlej Cotton Mills Supply Agency Ltd.*, (1975) 2 S.C.C. 538.

realizing a security or whether it is a gain made in an operation of business in carrying out a scheme for profit-making.

Thus, it is evident that the question whether an asset is a capital asset or a stock-in-trade depends on the intention and purpose of assessee in purchasing or acquiring that asset. It is to be noted that there is no straitjacket formula or test to determine intention – it has to be gathered from the facts and circumstances of the case.

When calculating income under Section 45 of the Income Tax Act, it is important to consider the inherent limitation that income derived from capital assets may be subject to taxation if it possesses a cost or a foreseeable cost.[74] The definition of capital asset encompasses all types of property. However, it has been established that the tax liability on capital gains applies only to capital assets that have a tangible or measurable cost during their acquisition, and not to assets where the tax liability is completely non-existent. Under such circumstances, capital gains will not be subject to taxation. This is because while the requirements of Section 45 may be met, it would be impossible to calculate them under Section 48. This is because the charging section and the computation provisions are considered as a unified code.[75] If, due to whatever cause, the computation provision cannot be implemented, the charge under Section 45 is invalidated. Sections 45 and 48 should be interpreted collectively as a cohesive code. In Section 48, the focus is on the methodology employed for calculating capital gain. According to this stipulation, in order to determine the taxable income, it is necessary to subtract the expenses solely and exclusively associated with the transfer, as well as the cost of acquiring the asset and any associated improvements, from the total value of consideration.

In *CIT v. B.C. Srinivasa Setty*,[76] the Supreme Court held that, Section 48 pertains to an asset that can be obtained at a cost. The inability to consider the cost of acquisition, as exemplified by the generation of goodwill in a newly established business, precludes the classification of it as a capital asset under Section 2(14). Consequently, the application

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[74] Chaturvedi & Pithisaria's, INCOME TAX LAW, 4183 (2020).
[75] *CIT* v. *B.C. Srinivasa Setty*, (1981) 2 S.C.C. 460.
[76] Dana Corporation, In re., (2010) 321 ITR 178 (AAR).

of capital gains taxation provisions is not applicable in such cases. However, it is important to acknowledge that there exists a distinction between the condition of being unable to determine the cost and the challenge of determining it. In the event of the former scenario, the legal framework would support the absence of accountability for the taxpayer.[77] The decision in CIT v. B.C. Srinivasa Setty has significant implications. It establishes that in situations where it is challenging to determine the (i) date of acquisition, (ii) cost of acquisition, (iii) date of transfer, and (iv) consideration for transfer, the gains resulting from such cases are not subject to liability under Section 45.[78] As a result of the decision's implications, the capital gains held by the taxpayer were not subject to taxation. Consequently, the legislature made amendments to Section 55, specifically the definition of "cost of acquisition" as stated in Section 55(2), by the Finance Act of 1987, effective from April 1, 1988. Following the modification, the cost of acquiring capital assets (in cases where there was no cost or it was challenging to determine cost) was considered to be zero. Consequently, the entire capital gain was subject to taxation.

If cryptocurrency is mined, the setup costs and equipment costs associated with mining it must be added to the acquisition costs. When a cryptocurrency is traded between unregistered parties, the cost of acquisition is the consideration used to purchase the currency. So, depending on how long and for what purpose the assessee held the cryptocurrency, it may be taxed as a short-term capital gain or a long-term capital gain.

VIII

Direct Tax implications on VDA after insertion of section 115BBH

Effective from 1 April 2022 onwards, any income from transfer of VDAs is taxable at the flat rate of 30% (plus surcharge and cess).[79] VDA has been defined in a wide manner to, inter-alia, include any information, code, number or token not being Indian or foreign currency, and generated through cryptographic means or others.[80] In

[77] *Supra,* note 76.
[78] *CIT* v. *D.P. Sandhu Bros. Chembur (P) Ltd.,* (2005) 2 S.C.C. 584.
[79] *Id.* S. 115BBH.
[80] *Id.* S. 2(47A).

the event of gifting of VDAs, the tax payment would be made by the recipient at the normal slab rates.[81] For the purpose of withholding, section 194S[82] was inserted with effect from 1 July 2022, which places an obligation on a person to ensure that tax, is withheld at the rate of 1% at the time of payment/credit of any sum to any resident as consideration for the transfer of a VDA.

Airdrops and Tax Ramifications

Airdrops involve the distribution of cryptocurrency tokens or coins directly to a specified wallet address, often without charge. This method is designed to raise awareness of the token and enhance the circulation of the new currency during its initial phases. However, it is crucial to understand that a 30% tax may be applicable to airdrops. The tax amount for airdrops is determined by Rule 11UA[83]. If you obtain cryptocurrency through airdrops and subsequently sell, exchange, or use your tokens, you will be liable to a 30% tax on your earnings. This tax is computed based on the market value of the token on the day it was received via an exchange.

IX

Concerns Regarding Taxation of Cryptocurrency (VDA)

Difficulties may arise in determining a taxpayer's taxable income or gains from the receipt or transfer of a VDA: Determining the person's taxable income in relation to the asset might be challenging when a VDA is received for nothing or for less than the asset's fair market value. In general, the value of cryptocurrencies and NFTs fluctuates greatly on a regular basis. As a result, determining the asset's fair market value may be challenging. It is generally accepted that the fair market value of a cryptocurrency purchased on a crypto-exchange or an NFT purchased on a marketplace is the price in effect at the time of the purchase. Although fair market value under the Income Tax Act is to be assessed in accordance with the Income Tax Regulations, 1962, this may not hold water with the income tax authorities (Rules). The Regulations do specify methods for figuring out the fair market value

[81] *Id.* S. 56(2) (X).
[82] *Id.* S. 194S.
[83] Income-tax Rules, 1962, R. 11UA.

of certain assets, but they are silent on how to value VDAs, therefore, leaving a lacuna.

When a person is required to pay tax on the transfer of a VDA, issues could also arise. The cost of acquisition is the only deduction allowed from the income obtained through the transfer of a VDA. The income and the cost of acquisition are clearly identifiable when a VDA is bought and sold for a certain sum in INR or in a foreign currency. The cost of acquisition and/or consideration for the transfer of the VDA, however, will be challenging to determine if a VDA is purchased with, or sold in exchange for, another VDA (for instance, an NFT is purchased using Bitcoin). This is because an exact INR value for the acquisition and/or transfer will not be readily available due to volatile nature of cryptocurrencies. The Government has also confirmed that expenditure incurred in mining cryptocurrency is considered capital expenditure and not a cost of acquisition. Therefore, the considerable expenditure on the hardware required to mine cryptocurrency cannot be deducted from any income derived from the transfer of cryptocurrency.[84]

Section 115 BBH(2)(b) provides that no set-off of loss from the transfer of the virtual digital asset shall be allowed against income computed under any other provision of this Act to the assessee.[85] Another issue in regards to set-off is whether loss sustained by assessee on sale or transfer of virtual digital assets prior to 31.03.2022 is allowed to be set off or carry forward: The law on this matter is not clear and there is ambiguity and assessee should take decision on basis of facts and circumstances. This move would clearly discourage the use of cryptocurrencies through legal channels and people would tend to restore to use these currencies through decentralized autonomous organisations which are difficult to trace and control.

Treatment of loss due to devaluation of stock-in-trade of Virtual Digital Asset is not yet clear. There may be two possibilities that is devaluation may occur due to change in price of the assets at stock exchanges or if

[84] Justin M Bharucha and Aashika Jain, *How Cryptocurrencies are Taxed in India*, Forbes Advisor (31 Oct. 2022) *available at-* https://www.forbes.com/advisor/in/investing/cryptocurrency/cryptocurrency-tax-in-india/ (last visited 3 Mar. 2023).

[85] The Income Tax Act, 1961, S. 115BBH(2)(b).

change in foreign exchange rates, if VDA purchased in any currency other than INR. Such notional losses may arise at the end of financial year of unsold stock of VDA. Issues may also arise at the time of sale of such VDA. Current Income-tax provisions do not provide any clarification on this matter.[86]

X

Recommendations

"Cryptocurrency profits can happen in many ways such as mining, farming, or general buying and selling", said Edul Patel, founder and CEO of San Francisco's cryptocurrency trading platform Mudrex.[87] The benefits of trading in digital assets can be categorized under 'business revenue', while other activities may fall below 'revenue from other sources'. Bringing additional rules or amendments will put unnecessary burdens on the taxpayer, he said.

In contrast to other types of legislation, tax rules should be continuously improved to deter tax evasion. Although the effectiveness of bitcoins as a medium of exchange is unproven, it looks incredibly revolutionary and exciting, therefore it merits careful consideration. In contrast to other developed nations, India has not yet established regulations for cryptocurrencies. Although, taxation has been introduced for the transfer of Cryptocurrency but it contains flaws and such tax regime tends to discourage investment in Cryptocurrency. Implementation of General Anti Avoidance Rules should empower the Department to some extent to review arrangements in cryptocurrencies entered for tax avoidance purposes. It is proposed that KYC norms currently applicable to financial institutions and banks be extended to bitcoin exchanges and wallet operators, as they remain the point of transaction in most cases.[88]

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[86] Direct Taxes Committee, *Handbook on Taxation of Virtual Digital Assets* (The Institute of Chartered Accountants of India, 2022).

[87] Hiral Thanawala, *Investing in cryptocurrencies made easier: Mudrex offers Coin baskets*, MONEYCONTROL *available at* - https://www.moneycontrol.com/news/business/personal-finance/mudrex-offers-coin-sets-do-they-make-investing-in-cryptocurrencies-simpler-7634221.html (last visited 26 Feb. 2023).

[88] Reserve Bank of India, Master Circular, Know Your Customer (KYQ norms/Anti-Money Laundering (AML) standards/Combating of Financing of Terrorism

Nevertheless, given what the future holds for bitcoins and blockchain technology, digital currency by RBI etc., there is no better time than now to establish clear rules and regulations both in relation to regulatory aspects and taxation (direct and indirect), to subsequently ensure their stability and security and for better investments in this regard.

XI

Conclusion

A new technology that will undoubtedly take over in the near future is cryptocurrency. It must therefore be legalized as soon as possible in India. The Prevention of Money Laundering Act, 2002 was amended by the government to include cryptocurrencies. In effect, this puts it in the same group as illegal activities such as the use of weapons, gambling, terrorism, and drugs. Although procedures attempt has been made to ensure that there are no unlawful transactions involving this digital money because the anonymity associated with its use is crucial to keep in mind and it may become a hindrance here as well. Results and effectiveness, however, favourable or unfavourable are yet to be seen. Regarding the taxation of cryptocurrencies, it is important to note that all transactions, regardless of their format, must be subject to taxation because, if taxed, they would bring in a sizable sum of money for the exchequer. Furthermore, it might be complicated to frame unambiguous guidelines to tax digital currency but as a start and after the Finance Act, 2022, there has been significant attention diverted to this area. Although, the policy has to conceive positive changes in this fast growing sector and, to attract investments and as of now this taxation regime seems discouraging and one accepts this now or not but this is going to be the future of the world and may turn into legal tender for numerous countries, considering the potential it has. Moreover, it is high time that India implements an indirect tax policy in this area.

(CFT)/Obligation of banks under Prevention of Money Laundering Act, (PMLA), 2002, RBI/2014-15/70 (Issued on July 1, 2014), available at: https://www.rbi.org.in/Scripts/Error.aspx?aspxerrorpath=/scripts/bs%20viewmascirculardetails.aspx#MC (last visited 26 Feb. 2023).