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TAXING CRYPTOCURRENCY TRANSACTIONS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Public Finance, Taxation & Black Money incl. Government Budgeting

“Since cryptocurrencies are unlike any other asset class, stored and traded virtually, there are varied challenges which need to be addressed in order to streamline the process of taxing crypto transactions.” | Photo Credit: Getty Images/iStockphoto

Notwithstanding the eventual introduction of the Cryptocurrency and Regulation of Official Digital Currency Bill in Parliament, cryptocurrencies continue to proliferate. In fact, a liberal estimate suggests that as many as 10 crore Indians may already have investments exceeding a total of $10 million in them. This not only creates an avenue for generation of tax revenue for the nation but also puts forth a Herculean challenge for the tax authorities who have to track and tax transactions involving cryptocurrencies.

Although the Income Tax Act, 1961 (“IT Act”) does not specifically mention cryptocurrencies, it does cast a wide enough net to bring crypto transactions under its ambit. Trading in cryptocurrency may be classified as transfer of a ‘capital asset’, taxable under the head ‘capital gains’. However, if such cryptocurrencies are held as stock-in trade and the taxpayer is trading in them frequently, the same will attract tax under the head ‘business income’. Even if one argues that crypto transactions do not fall under the above heads, Section 56 of the IT Act shall come into play, making them taxable under the head ‘Other sources of income’.

Government to change tax laws in Budget to tax cryptocurrency gains

However, this in itself is not sufficient in order to put in place a simple yet effective taxation regime for cryptocurrencies. Since cryptocurrencies are unlike any other asset class, stored and traded virtually, there are varied challenges which need to be addressed in order to streamline the process of taxing crypto transactions.

First, the absence of explicit tax provisions has led to uncertainty and varied interpretations being adopted in relation to mode of computation, applicable tax head and tax rates, loss and carry forward, etc. For instance, the head of income under which trading of self generated cryptocurrency (currencies which are created by mining, acquired by air drop, etc.) is to be taxed is unclear. If these are taxed under capital gains, what should be taken as the cost of acquisition for the purpose of computation? If the acquisition cost is to be taken as the fair market value of the said cryptocurrency as on date of generation, how does one arrive at this value? Since there is no consistency in the rates provided by the crypto-exchanges, it is difficult to arrive at a fair market value. Conversely, there are divergent views in the market treating such an income as ‘business income’ or ‘other sources of income’, which are taxable at individual tax rate slabs (which may be higher than those applicable to capital gains). Similarly, when a person receives cryptocurrency as payment for rendering goods or services, how should one arrive at the value of the said currency and how should such a transaction be taxed?

Second, it is often tricky to identify the tax jurisdiction for crypto transactions as taxpayers may have engaged in multiple transfers across various countries and the cryptocurrencies may have been stored in online wallets, on servers outside India. In such cases, it becomes difficult to pinpoint which jurisdiction’s tax laws would become applicable and what kind of tax treatment would be effected especially in light of various nations having differing tax treatment for crypto assets including imposition of a general ban on them.

Is the crypto asset boom sustainable?

Third, the identities of taxpayers who transact with cryptocurrencies remain anonymous. Each crypto address comprises a string of alphanumeric characters and not the person’s real identity, giving tax evaders a cloak of invisibility. Exploiting this, tax evaders have been using crypto transactions to park their black money abroad and fund criminal activities, terrorism, etc.

Fourth, the lack of third party information on crypto transactions makes it difficult to scrutinise and identify instances of tax evasion. One of the most efficient enforcement tools in the hands of Income Tax Department is CASS or ‘computer aided scrutiny selection’ of assessments, where returns of taxpayers are selected *inter alia* based on information gathered from third party intermediaries such as banks. However, crypto-market intermediaries like the exchanges, wallet providers, network operators, miners, administrators are unregulated and collecting information from them is very difficult. Another consequence of this lack of information is that the tax authorities are left with hardly any tools to verify any crypto transactions which do get reported. They are instead forced to fully depend on the data provided by the taxpayers.

The crypto assets conundrum

Fifth, even if the crypto-market intermediaries are regulated and follow Know Your Customer (KYC) norms, there remains a scenario, where physical cash or other goods/services may change hands in return for cryptocurrencies. Such transactions are hard to trace and only voluntary disclosures from the parties involved or a search/survey operation may reveal the tax evaders.

While the aforementioned challenges provide enough food for thought to policymakers, certain steps can be taken to provide a robust mechanism for taxing crypto transactions going forward.

To begin with, the income-tax laws pertaining to the crypto transactions need to be made clear by incorporating detailed statutory provisions. These could include provision of a definition for crypto assets for tax purposes and guidelines addressing the major taxable events and income forms associated with virtual currencies. This should be followed by extensive awareness generation among the taxpayers regarding the same.

The year of the Doge? 2021, crypto’s wildest year yet

The practice of having separate mandatory disclosure requirements in tax returns (as is the case in the United States) should be placed on the taxpayers as well as all the intermediaries involved, so that crypto transactions do not go unreported. Additionally, the existing international legal framework for exchange of information should be strengthened to enable collecting and sharing of information on crypto-transactions. This will go a long way in linking the digital profiles of cryptocurrency holders with their real identities.

Furthermore, the Government must impart training to its officers in blockchain technology. In this regard, it may be noted that the United Nations Office on Drugs and Crime’s ‘Cybercrime and Anti-Money Laundering’ Section (UNODC CMLS) has developed a unique cryptocurrency training module, which can aid in equipping tax officers with requisite understanding of the underlying technologies. Tax authorities should also equip themselves with the latest forensic software (such as Elliptic Forensics Software is being used by the USA Internal Revenue Service and GraphSense used in the European Union) which can analyse a high volume of crypto transactions at a time and raise red flags in cases of suspicious transactions.

Private cryptocurrencies pose immediate risks to customer protection, prone to frauds: RBI

It is certain that cryptocurrencies are here to stay. A streamlined tax regime will be essential in the formulation of a clear, constructive and adaptive regulatory environment for cryptocurrencies.

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A new form of ‘Gandhian’ democratic socialism powered by cooperative economic enterprises is required

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