TAXING CRYPTO-CURRENCIES

The concept, the challenges, and the required changes

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A. Introduction

1. Background

The world has been in the throes of a technological revolution and India is no different. The adoption of technology has fundamentally altered every aspect of life in India and the COVID-19 pandemic has further accelerated this paradigm shift. With one of the world's fastest-growing economies, and on the back of hugely successful indigenously developed products such as the Unified Payment Interface, India has emerged as one of the fastest-growing fintech hotspots in the world. In alignment with its image as a fintech hotspot, the nation has been open to embracing technologies such as the blockchain, that are likely to play a pivotal role in the financial ecosystem going forward. Most recently, in the Union Budget 2022-2023, the Finance Minister even announced plans to launch a Central Bank Digital Currency or Digital Rupee.[1] However, policymakers' and regulators' take on embracing emerging tech in the fintech space takes a hard stop at the doorstep of cryptocurrencies. The "private" crypto ecosystem in India has seen a slew of regulatory action against it.

Most notably, the Reserve Bank of India ("**RBI**") has been a staunch and unforgiving critic. After repeatedly cautioning[2] users of the various risks associated with dealing in cryptocurrencies, in April 2018, RBI directed all regulated entities including banks to deny services to businesses dealing in virtual currencies, including cryptocurrencies.[3] The Supreme Court later set the circular aside on the grounds of proportionality.[4] However, the RBI continues to make its view of the ecosystem clear, often comparing it to scams such as Ponzi schemes[5] and tulipmania[6]. Due to the lack of support from the traditional banking sector, most crypto exchanges relied on Mobikwik for UPI deposits which cut off its services in April 2022.[7] It is reported that Mobikwik was having difficulty obtaining a payment aggregator license since it was serving crypto-exchanges.[8] Most crypto-exchanges also disabled the UPI deposit option after a statement from the National Payments Corporation of India issued a statement clarifying that it was not aware of any crypto exchanges using UPI.[9]

Besides regulatory actions, there have also been concerted efforts to "ban all private cryptocurrency". Most notably, a bill in this regard was set to be placed before the Parliament in its winter session in late 2021.[10] Though this bill has not been made public yet and was never actually placed before the Parliament, it disrupted the crypto ecosystem in India. In parallel, other disincentives have continued. For instance, the Advertising Standards Council of India which is a self-regulatory organisation of the Indian advertising industry, came out with guidelines to regulate the advertising and promotion of cryptocurrencies. It noted that several crypto advertisements did not adequately disclose the risks associated with such products. The guidelines required all

[1] Ministry of Finance, Press Release dated 1 February 2022 available at <https://pib.gov.in/PressReleasePage.aspx?PRID=1794160> [Last accessed April 2022].
[2] RBI Press Releases: 2017-2018/1530 dated 5 December 2017; 2016-17/2054 dated 1 February 2017, 2013-2014/1261 dated 24 December 2013.
[3] Prohibition on dealing in Virtual Currencies (VCs), RBI/2017-18/154, DBR.No.BP.BC.104 /08.13.102/2017-18, 6 April 2018, available at <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11243>.
[4] *Internet and Mobile Association of India v. Reserve Bank of India*, Writ Petition (Civil) Nos. 528 and 373 of 2018, Decided On: 04.03.2020, MANU/SC/0264/2020MANU/SC/0264/2020.
[5] Meghna Sen, "*Banning crypto the most advisable choice open to India: RBI Debputy Governor*", Livemint (14 February 2022) available at <https://www.livemint.com/market/cryptocurrency/banning-crypto-the-most-advisable-choice-open-to-india-rbi-deputy-governor-11644851315064.html> [Last Accessed April 2022].
[6] Author, "*Warning Indians against cryptocurrencies*, RBI chief says tulips have more value", Economic Times (10 February 2022) <https://economictimes.indiatimes.com/news/economy/policy/cryptos-a-threat-to-financial-stability-value-not-even-a-tulip-shaktikanta-das/articleshow/89474805.cms?from=mdr> [Last Accessed April 2022].
[7] Sarvesh Mathi, "*Major Crypto Exchanges Are Unable To Use UPI For Fund Deposits, Leading To Significant Drop In Trade Volumes*" Medianama (13 April 2022) available at <https://www.medianama.com/2022/04/223-crypto-upi-fund-deposits-disabled/>
[8] Aroon Deep, "*RBI rejection looms over Mobikwik's payment aggregator license*", ENTRACKR (11 April 2022) available at <https://entrackr.com/2022/04/exclusive-rbi-rejection-looms-over-mobikwik-payment-aggregator-license/>.
[9] Note 7 *supra*.
[10] Asit Ranjan Mishra, Prasid Banerjee, "*Govt. to move bill to ban all private cryptocurrencies*", Livemint (24 November 2021) available at <https://www.livemint.com/market/cryptocurrency/govt-to-move-bill-to-ban-all-privatecryptocurrencies-11637693131165.html> [Last accessed April 2022].

such advertisements to carry the disclaimer that "*Crypto products and NFTs are unregulated and can be highly risky. There may be no regulatory recourse for any loss from such transactions.*" It also required the disclaimer to be carried in such a manner that it is prominent and unmissable by an average consumer.

On the tax front too, there has been an immense lack of clarity. Back in 2021, Minister of State for Finance, Mr. Anurag Singh Thakur had said in response to a question in the Rajya Sabha that "*the gains resulting from the transfer of cryptocurrencies/assets are subject to tax under the head of income, depending upon the nature of holding of the same*". However, within a span of a year since this aforementioned statement, the Ministry of Finance took a completely different and classification agnostic approach to taxing cryptocurrencies. In the Budget for the Financial Year 2022-23, the Finance Minister made four key amendments to the Income-tax Act, 1961 ("**IT Act**"). The Finance Act 2022 inserted:

(i) Section 2(47A) to define virtual digital assets;
(ii) Section 115BBH that specifies the rate at which transfer of these 'virtual digital assets' will be liable to income-tax, the rate pf tax being 30 percent;
(iii) An explanation under clause (x) of section 56(2) to the effect that property would include 'virtual digital asset'; and
(iv) Section 194S that provided for tax deduction at source on payment towards consideration for transfer of virtual digital assets.

The above framework took effect from 1st April 2022. However, income-tax was payable on transactions in cryptocurrency prior to 1st April 2022 as well. The amount of tax payable was dependent on the classification of cryptocurrencies – either as a capital asset or as stock in trade. Further, a separate framework for taxing cryptocurrencies as it now exists in the IT Act, is not elucidated under the Goods and Service Tax ("**GST**") framework as yet. Discussions on the classification of cryptocurrencies under the CGST Act are still at a nascent stage.[11] Though, services provided by crypto-exchanges are taxable at 18%. Questions relating to valuation, place of supply, etc. for the purposes of levy of a goods and services tax are still unanswered.

The quashing of the 2018 RBI circular by the Supreme Court breathed life into the crypto movement. Start-ups in the crypto ecosystem amped up efforts to increase adoption of crypto through several means such as tying up with celebrities from social media, sports and Bollywood to market cryptocurrency investments on the internet. More "conventional" avenues such as newspapers and leading sports tournaments including the Indian Premiere League and the T20 Cricket World Cup were also flooded with advertisements by crypto exchanges, some of them claiming 4x more interest than fixed deposits.[12] The hostility of regulators, however, severely eroded trading volumes on leading exchanges leaving a dent in their customer base and consequently, revenue.[13]

The popularity of cryptocurrency in India is clear from the fact that it houses 10.07 crore crypto owners, which is more than every other country in the world.[14] It is now a long-settled position that the legality of or manner of acquiring income has no bearing on its taxability.[15] Therefore, a lack of clarity with respect to its tax treatment is not only depriving the crypto community of certainty and stability, but it is also robbing the nation's treasury of its fair share of tax revenue. This working paper studies the income tax and GST framework applicable to cryptocurrencies. It studies the status quo and recommends a way forward, regardless of the nation's stand on

[11] Press Trust of India, "*Govt working on classification of cryptocurrency under GST law*", available at <https://economictimes.indiatimes.com/news/economy/policy/govt-working-on-classification-of-cryptocurrency-under-gst-law/articleshow/90333798.cms> [Last Accessed March, 2022].
[12] Apoorva Mittal, "*Experts raise alarm over crypto advertisements*", ETtech, (4 November 2021), available at <https://m.economictimes.com/tech/technology/experts-raise-alarm-over-crypto-advertisements/articleshow/87518841.cms?_oref=cook> [Last Accessed March, 2022].
[13] Apoorva Mittal, "Trading volumes on top crypto exchanges touch six-month low", ETPrime (12 April 2022) available at <https://economictimes.indiatimes.com/tech/technology/trading-volumes-on-top-crypto-exchanges-touch-6-month-low/articleshow/90784815.cms>.
[14] Press Trust of India, "*India has highest number of crypto owners in the world at 10.07 crore: report*", Livemint (13 October 2021) available at <https://www.livemint.com/market/cryptocurrency/india-has-highest-number-of-crypto-owners-in-the-world-at-10-07-crore-report-11634110396397.html> [Last Accessed March, 2022].
[15] *Commissioner of Income-tax v. K. Thangamani* [2009] 309 ITR 15 (Madras); *V.V. Minerals [100% EOU] v. Commissioner of GST & CE (CESTAT Chennai)*, Service Tax Appeal Nos. 40343 to 40346 of 2020-DB.

the regulatory aspect of cryptocurrencies. While the lack of clarity on key regulatory aspects of cryptocurrencies in India is acknowledged, it is not addressed in this working paper. The findings of this paper are agnostic to such regulatory aspects. However, the Vidhi Centre for Legal Policy's report titled 'Blueprint of a Law for regulating Crypto-assets'[16] proposes a regulatory framework for crypto assets in India and may be referred to.

This working paper has six chapters. Chapter A starts by contextualising the issue at hand and defines the key terms used in the rest of the paper. Chapter B deals with the issue of classification of cryptocurrencies. It studies how cryptocurrencies would be classified both under the income tax and the GST framework. Chapter C identifies the taxable event in cryptocurrencies' lifecycle. It broadly studies three such potential taxable events – the creation of cryptocurrencies, their initial distribution or acquisition, and their subsequent disposal. The taxable events are analysed to study both income tax and GST liability. Notably, the income tax assessment conducted across the working paper is divided in two parts - one to ascertain the income tax treatment prior to the changes made through Union Budget 2022, and two to ascertain income tax implications post such change. A jurisdictional analysis is then conducted in Chapter D. This chapter studies both the income tax and GST treatment of cryptocurrencies in several different jurisdictions. The study includes an analysis of how other jurisdictions classify cryptocurrencies and determine taxable events.

The final chapter of the working paper concludes that the income tax framework introduced in the 2022-2023 Union Budget poses several key operational issues, it violates key principles of tax policy and should be done away with. Instead, cryptocurrencies should be taxed for income tax purposes under the regime that applied prior to the 2022 framework. However, the manner in which such tax would apply should be clarified. For instance, there are multiple players participating in the entire lifecycle of cryptocurrencies, from creation to final disposal. This results in various potential taxable events. Accordingly, clarity with respect to which events would be taxable and the factors that will help determine whether holding a cryptocurrency unit would amount to a capital asset or a stock-in trade in different situations will be of paramount importance. Further, a significant challenge in effectively taxing cryptocurrencies is ascertaining their value. For one, cryptocurrencies are notoriously volatile. Secondly, there is no consistency in the value of cryptocurrencies. Their prices vary between platforms and even between geographies. For instance, the price of Bitcoin fell sharply on Indian exchanges as a response to factors that impacted its local demand and supply.[17] Hence, going forward, certainty with respect to valuation of cryptocurrencies will be required. Additionally, given that any taxation framework typically places substantial emphasis on the situs of the taxable event while ascertaining the tax liability. Therefore, clear guidelines with respect to situs of cryptocurrency are required to ensure that the ecosystem is taxed in an efficient manner.

On the GST front, this paper believes that most cryptocurrencies will fall outside the ambit of "money" as defined under the current GST framework. This interpretation of the definition of "money" is yet to be tested at court in the Indian context. The concept of "money" and "currency" has considerably evolved over the years. The existing laws were written without contemplating technological advancements such as cryptocurrencies. While it is clear that cryptocurrencies do not qualify as legal tender, there may still be scope to argue that they fall under the broader ambit of "money". The implications of this uncertainty around the classification of cryptocurrencies are substantial. Their inclusion under the ambit of "money" will essentially exclude the applicability of GST on transactions such as their exchange for fiat currency. If cryptocurrencies are considered to qualify as "goods" which appears to be a more plausible conclusion under the existing framework, several GST implications will ensue. First, a much larger number of events will amount to taxable supplies, than if cryptocurrencies are considered as "money". Second, given the volatility, and lack of standardisation in the value of cryptocurrencies, valuing transactions will pose a significant challenge. This challenge is specifically exacerbated in the GST scenario where tax is levied on the value add and credit of tax paid on inputs is allowed. Given that the volatility associated with cryptocurrencies is unique, the existing GST framework does not account for occurrences. Lastly,

[16] Shehnaz Ahmed and Swarna Sengupta, "*Blueprint of a Law regulating for regulating Cryptoassets*" (January 2022) available at <https://vidhilegalpolicy.in/research/blueprint-of-a-law-regulating-cryptoassets/> [Last accessed March 2022].

[17] *Explained: Why was bitcoin trading cheaper in India today compared to global prices?*, CNBCTV18.com (November 24, 2021) <https://www.cnbctv18.com/cryptocurrency/explained-why-was-bitcoin-trading-cheaper-in-india-today-compared-to-global-prices-11578612.htm> [Last accessed February, 2022].

the GST implications of a transaction vary significantly depending on the location of the parties involved in a transaction. Given the decentralized and pseudo-anonymous nature of cryptocurrency transactions, ascertaining this location, may also be an extremely difficult task.

With the proliferation of cryptocurrencies, the concept of money is evolving at a rapid speed. While this evolution poses several pertinent threats, it also offers many valuable opportunities. Most of the challenges associated with cryptocurrencies can be effectively addressed by designing an appropriate regulatory framework. The taxation framework should thus be designed such that taxes do not factor into investment or business decisions. They should not be designed to disproportionately encourage or deter activity in this space. Their sole aim should be to earn revenue, without stifling innovation and development of the ecosystem. With this aim in mind, it is suggested that an assessment should be conducted on whether cryptocurrencies qualify as "goods" or "money" under the GST framework and the issue should be clarified. If it is concluded that they constitute "goods", then an amendment should be made to the GST law specifically including cryptocurrencies to the definition of goods.

2. Defining key terms

In order to determine the tax implications of transactions that involve cryptocurrencies, it is first imperative to define the term. There already exists a considerable amount of literature on the topic, both from India and from other jurisdictions. This section of the working paper hence reviews the existing literature to define and where applicable, differentiate between the key terms in the ecosystem of virtual currencies.

The Supreme Court, in the case of *Internet and Mobile Association of India v. Reserve Bank of India* (*supra*) conducted a detailed analysis into the existing literature on the matter. It extensively quoted the Financial Action Task Force ("**FATF**") report titled 'Virtual Currencies Key Definitions and Potential AML/CFT Risks'.[18] The FATF in this report defines 'virtual currency' as a digital representation of value that can be traded digitally and functions as (i) a medium of exchange; (ii) a unit of account; and/or (iii) a store of value, but not having a legal tender status in any jurisdiction. It is not issued, nor guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency.[19] The report further distinguishes between e-money and virtual currency and defines the former as a digital representation of fiat currency used to electronically transfer value denominated in fiat currency.[20] Due to this fundamental distinction between virtual currency and legal tender, many believe that the expression virtual "currency" can be misleading.[21] The expression "payment tokens" is therefore often used to more precisely denote the concept of "virtual currencies" and can usually be interchangeably used.

There are also multiple types of virtual currencies, that may include convertible, non-convertible, centralized, and decentralized currencies. Decentralised virtual currencies that are convertible into fiat currencies are also popularly known as cryptocurrencies and form the primary focus of this working paper. The term 'Cryptocurrency' is defined in the FATF report to mean a math-based, decentralised convertible virtual currency protected by cryptography by relying on public and private keys to transfer value from one person to another and signed cryptographically each time it is transferred.[22]

Virtual currencies form a sub-set of the wider, increasingly popular expression "crypto-assets". Crypto-assets typically include virtual currencies (i.e., payment tokens), utility tokens and security tokens. While the notion that these seemingly distinct categories actually exist on an overlapping spectrum and in some cases, may mutate

[18] FATF Report, Virtual Currencies Key Definitions and Potential AML/CFT Risks (June 2014) available at <https://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf> [Last accessed January, 2022].
[19] *Ibid.*
[20] *ibid.*
[21] OECD (2020), "*Taxing Virtual Currencies: An Overview of Tax Treatments and Emerging Tax Policy Issues*", OECD, Paris, available at <www.oecd.org/tax/tax-policy/taxing-virtual-currencies-an-overview-of-tax-treatments-and-emergingtax-policy issues.htm>[Last accessed January, 2022].
[22] Note 18 *supra*.

over the course of a token's lifetime is acknowledged, this working paper focusses only on cryptocurrencies (as defined above) that form a sub-set of virtual currencies.

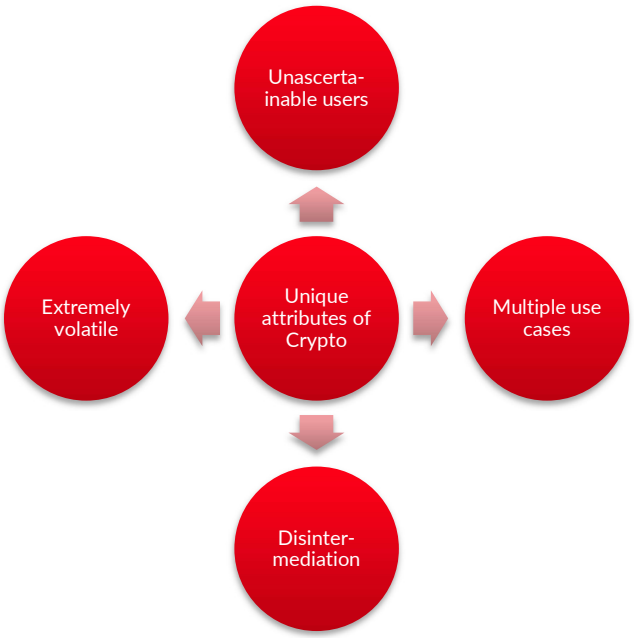
Further, for the limited purpose of this working paper, the term 'cryptocurrency' is deemed to exclude stablecoins. Stablecoins are often defined to mean "crypto-assets that aim to maintain a stable value, relative to a specified asset, or a pool or a basket of assets".[23] There are several similarities between stablecoins and other more traditional cryptocurrencies such as Bitcoin and Ether. They both fall under the broader ambit of "virtual currencies" or "payment tokens" as defined above, rely on cryptography, and decentralisation is an essential characteristic of both. However, stablecoins aim to minimise volatility and maintain a stable price vis-à-vis a given benchmark, which may be a fiat currency (or a basket of fiat currencies), a commodity, another virtual asset or an algorithm. While ascertaining the tax implications of cryptocurrencies, this working paper bases a lot of the assessment on their features, which are broadly homogeneous. Given that stablecoins have a significant and fundamentally unique feature in a more stable value, their tax assessment merits separate evaluation. Similarly, utility tokens and security tokens have been kept outside the scope of this working paper as they have a distinct set of characteristics and use cases that prevent them from being clubbed in the broadly homogeneous block of cryptocurrencies as defined under this working paper.

Further, this working paper conducts a detailed analysis over the applicability of two primary forms of taxes - income tax and goods and services tax on transactions such as acquisition or transfer of cryptocurrencies. Several other levies such as customs duty, stamp duty, equalization levy and property tax[24] are also applicable in India, however those are outside the scope of this working paper Additionally, the scope of this working paper analyses the tax implications from an Indian perspective and cross border implications under instruments such as Double Tax Avoidance Agreements have not been addressed. Lastly, the working paper does not cover tax implications in the hands of the intermediaries and their income. It focusses on the complexities surrounding the tax treatment of the transfer.

[23] Note 21 *supra.*
[24] Property tax is only applicable to immoveable property and is accordingly not applicable in the case of cryptocurrencies.

B. Classification of cryptocurrencies

Cryptocurrencies were designed to perform three primary functions. They may be used as a medium of exchange, stores of value, and units of account. However, they also have several unique features. For instance, they are digital, encrypted, and decentralized. These features render it tricky to universally classify cryptocurrencies under any existing class of financial instruments. While there are certain aspects of cryptocurrencies that overlap with that of fiat currencies or money, cryptocurrencies may be distinct from them. The challenges associated with characterization and classification of cryptocurrencies pose hurdles in effectively regulating the sector and have been extensively discussed in Vidhi's report titled 'Blueprint of a Law regulating for regulating Cryptoassets'[25]. This issue is equally relevant from a taxation standpoint as it crucial to classify cryptocurrencies in order to determine their tax implications. This section of the working paper studies the possible categories under which cryptocurrencies may be classified for the purposes of taxation.



1. Indian income-tax regime

The Central Government, through the IT Act levies tax on income of both individuals and corporations. Residents of India are subject to tax on their worldwide income (i.e., based on the residence rule) whereas non-residents (and not ordinarily residents) are subject to tax in India only on income that is sourced in India (i.e., based on the source rule). Therefore, an Indian tax incidence arises on income where either the (i) residency criteria; or (ii) the source rule is satisfied. In other words, residents are liable to tax on their global income, whereas non-residents are taxed in India only if "*any income arises or accrues or is deemed to arise or accrue in India*".[26] The key aspect for taxability under the income tax framework is *income*. Therefore, for the purpose of the income tax framework, the primary question that arises is whether any earnings or income from cryptocurrencies would qualify as income.

The IT Act defines the term "income" in a broad manner.[27] It further stipulates "heads of income" under which all income needs to be classified for the purpose of charge of income-tax.[28] This list *inter alia* includes 'profits and gains from business or profession', 'capital gains' and 'income from other sources'. [29] The latter acts as a

[25] Note 16 *supra*.
[26] Income-tax Act, 1961, Section 9.
[27] Income-tax Act, 1961, sub-section (2) of Section 24.
[28] Income-tax Act, 1961, Section 14.
[29] Income-tax Act, 1961, Section 14.

residual category to include various types of income that do not qualify under any other specific head of income.[30] There are separate provisions that dictate the mechanism for computing the manner of payment and the amount of tax payable under each of these heads of income. Classifying income under the appropriate heads is thus a critical aspect of computing income tax liability under the IT Act.

The Supreme Court in ***Commissioner of Income-tax v. G.R. Karthikeyan***[31] has observed that the idea behind providing an inclusive definition of income under section 2(24) of the IT Act is not to limit its meaning but to widen its net and the word 'income' is of widest amplitude, and that it must be given its natural and grammatical meaning. Accordingly, any income earned from cryptocurrency would naturally fall within the ambit of the IT Act.

1.1. Before Financial Year 2022-23

As set out above, for the purpose of tax computation, income can be categorised under the head "capital gains". This category seeks to tax gains made from transfer of a 'capital asset'. As per the provisions of the IT Act, the term 'capital asset' refers to "property of any kind" that is held by a person subject to certain exceptions such as personal effects, stock-in trade (i.e., inventory) etc. The term property is defined under the IT Act in the context of Income from other sources and not in relation to income under any other head. This definition is very restrictive and includes only certain items like immovable property being land or building or both, shares and securities, jewellery, drawings, paintings, etc. This definition is not relevant for the definition of capital assets due to its limited applicability. The Benami Transactions (Prohibition) Act, 1988 defines property as property of any kind, whether movable or immovable, tangible, or intangible, and includes any right or interest in such Property.[32] In Black's Law Dictionary[33], the expression "property" has been given the following meanings:

- that which peculiar or proper to any person;
- that which belongs exclusively to one.

The term "property' encompasses every species of valuable right and interest. More specifically, it means ownership; the unrestricted and exclusive right to a thing; the right to dispose of a thing in every legal way, to possess it, to use it, and to exclude everyone else from interfering with it. That dominion or indefinite right of use or disposition which one may lawfully exercise over particular things or subjects. The exclusive right of possessing, enjoying, and disposing of a thing.[34] Term includes not only ownership and possession but also the right of use and enjoyment of lawful purposes.[35]

The dictionary further says "property is either: real or immovable; or, personal or moveable". It then proceeds to give the meaning of the expression "absolute property", "common property", "intangible property", "moveable property", "personal property", "private property" and "public property" among others. The above definition denotes the wide meaning attached to the expression.[36]

Further, Jowitt's Dictionary of English Law[37], defines general and special property. While the definition of general property is akin to the definition of property elucidated in Black's Law Dictionary above in as much as it indicates absolute ownership, special property refers to ownership where the subject-matter is incapable of being in the absolute ownership of any person. A man may have a property in deer in a park, hares or rabbits in a warren, fish in a pond, etc., but it is only a special or qualified property, for if at any time the animals regain their natural liberty his property instantly ceases, unless they have *animus revertendi*.

[30] Income-tax Act, 1961, Section 56.
[31] *CIT v. G.R. Karthikeyan* (1993) 112 CTR (SC) 302).
[32] Benami Transactions (Prohibition) Act, 1988, clause (c) of Section 29.
[33] Black's Law Dictionary, (6th Edition, 1990).
[34] *Vikas Sales Corpn. v. CCT*, (1996) 4 SCC 433, p 442.
[35] *Hoffmann v. Kinealy, Mo*, 389 S W 2d 745, p 752.
[36] *Vikas Sales Corpn. v. CCT*, (1996) 4 SCC 433, p 442.
[37] Jowitt's Dictionary of English Law (Sweet and Maxwell Limited, 1977) Vol. I.

Incorporeal rights like trademarks, copyrights, patents and rights in person capable of transfer or transmission, such as debts, are also included within the ambit of property.[38] Accordingly, before the Budget announcements for the Financial Year 2022-23, an argument could be made that cryptocurrency units held by a taxpayer as investment would fall within the broad definition of property and consequently also "capital gains"

The question then arises as to under which head of income would cryptocurrency units held in the nature of stock-in trade be classified. This question is relevant given that the same property can be classified under a different head of income (i.e., capital gains and income from business and profession) based on the nature of holding the property. The taxing mechanism for both heads of income differ substantially. While the consideration from the transfer of a capital asset is taxed at a fixed rate depending on the period of holding and type of asset, the consideration from transfer of stock-in trade is taxed at ordinary slab rates.

The Central Board of Direct taxes ("**CBDT**") with respect to classification of shares as capital assets or stock-in-trade has held that factors such the nature of transactions, the manner of maintaining books of accounts, the magnitude of purchases and sales and the ratio between purchases and sales and the holding would furnish a good guide to determine the nature of transactions. Hence, based on these earlier clarifications[39] it may be possible to take a view that cryptocurrency transferred by a casual consumer is a capital asset while a trader could possibly treat them as stock in trade.

1.2. Financial Year 2022-23 onwards

In her Budget for the Financial Year 2022-23, Finance Minister Nirmala Sitharaman deviated from the speculated classification of cryptocurrencies, and introduced a framework that does not require classification of cryptocurrencies within the traditional categories of capital assets or stock in trade, etc. The Finance Act, 2022 inserted clause (47A) under Section 2 of the IT Act to define "virtual digital assets" or VDAs.[40] As per the definition, VDA is any information, code, number or token generated through cryptographic means or otherwise. The definition is broad enough to cover cryptocurrencies as we know them today and also accounts for future developments in the crypto ecosystem by not restricting itself to just tokens. The definition further carves out both Indian and foreign currency from its ambit, the definition of which it seeks from the Foreign Exchange Management Act, 1999 ("**FEMA**").

Non-fungible tokens ("**NFTs**") are also specifically included in the definition but will cover only such digital assets as the government may notify in the future. There is some legroom in the definition in this behalf, where the government has reserved the power to include or exclude any 'digital assets' from the definition of VDAs subject to such conditions as may be specified.

1.3. Challenges

Is Bitcoin Foreign Currency?

Foreign currency under the FEMA means any 'currency' other than Indian currency. Globally, there is a consensus that cryptocurrencies are not legal tender. An exception to this trend is El Salvador which officially adopted Bitcoin as legal tender making it a means of exchange for goods and services in the country.[41] This throws of the rather straightforward and simple understanding that the definition of VDA will cover Bitcoins and also hence, tax transfers of the same. An interpretation that the definition does not lead to taxation of transfer of Bitcoins may render the entire crypto-taxation framework fruitless for the revenue. Most certainly, carving out Bitcoin

[38] *Vikas Sales Corpn. v. CCT*, (1996) 4 SCC 433, p. 444.
[39] Central Board of Direct Taxes, Circular No. 4/2007 dated 15 June 2007.
[40] Finance Bill, 2022, clause (b) of Section 3.
[41] Euronews, "*Bitcoin battered and bruised as El Salvador officially adopts the crypto as a legal currency*", updated on 9 September 2021, available at <https://www.euronews.com/next/2021/09/07/el-salvador-makes-history-as-bitcoin-is-officially-adopted-as-a-currency-but-not-without-i>.

from the definition of VDA does not seem to the legislative intent. Although Bitcoin may be legal tender in certain foreign countries, the definition of 'currency' under the FEMA is restrictive in as much as it includes currency notes, postal notes, postal orders, cheques, money or drafts or such similar instruments etc. However, this differential approach at the global level will create challenges in classification for taxation purposes.

Unintended victims

Unintended victims of the definition of VDAs could also be debit card or credit card holders who earn reward points which are also generated through electronic means. For instance, a debit card holder may become eligible for some instant or deferred points at the time of completing a payment transaction. These points may be redeemed later to avail reduced prices on purchases. These reward points are not in the nature of cashbacks which are otherwise taxable under the head income from other sources. Therefore, when the points accrue to the card holder, no income tax implication arises. The tax implications arise subsequently, when the card holder redeems those points. If the subsequent expenditure is for business purposes, like purchase of inventory, the cost of inventory will be reduced to the extent of the monetary benefit on redemption of points. If the subsequent purchase is for personal use, no tax implications arise. Since the definition of VDAs employs the phrase "any information, code, number or token generated through cryptographic means ***or otherwise***", a tax liability could be triggered as soon as these points are earned and whether or not they are utilised for business use. Experts think that they may become taxable[42].

Negative impact on the industry

It is clear that the intention of the government was to discourage speculative trading in cryptocurrencies. While there is a global dip in the crypto market cap owing to the Russia-Ukraine crisis, several exchanges have blamed the high rate of tax under the new regime for negatively impacting the industry. There are several players in the cryptocurrency ecosystem such as miners, traders and investors that operate in different capacities. Owing to a common definition of VDAs, a flat rate of 30 per cent (plus applicable surcharge and cess) is applicable on all cryptocurrency transfers regardless of the nature of the transaction. In other words, a person earning income from transfer of cryptocurrency tokens held as stock-in trade would be treated at par with a person transferring tokens held as investment. This may disrupt the growth of the industry given that the income of cryptocurrency traders will not be taxed at ordinary slab rates (unlike traders of any other commodity) but instead at a higher rate. Additionally, traders will also not be allowed to claim business expenses or carry forward losses. Further, investors will be subject to the same rate of tax irrespective of the period of holding. Hence, the new regime steps away from the settled principles of tax law wherein paramount importance is given to the essence of every transaction and a clear distinction has always been maintained between transfer of capital assets and stock-in-trade.

2. *Indian GST regime*

Unlike the income tax framework that was specifically amended to address implications on transactions in cryptocurrencies, the levy of GST on this ecosystem has been unclear. The GST framework in India taxes the "*supply of goods or services or both*". The word "supply" is further defined to include "*all forms of supply of goods or services or both such as sale, transfer, barter, exchange, license, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business*". In order to determine the GST implications of transactions in the cryptocurrency ecosystem, it is thus imperative to assess whether these transactions constitute:

(i) a supply of goods or services or both;
(ii) is made or agreed to be made for a consideration; and
(iii) by a person in the course or furtherance of business.

[42] India Budget 2022: Decrypted, 1 February 2022, available at < https://www.nishithdesai.com/generateHTML/5267/3>.

Further, if a transaction is said to satisfy the aforementioned conditions, it needs to further be assessed whether it falls outside the ambit of "exempt supplies" and "zero rated supplies". This section of the working paper conducts this analysis to ascertain the GST liability of transactions in the cryptocurrency ecosystem.

The term "supply" is defined under the CGST Act to include "*all forms of supply of goods or services or both such as sale, transfer, barter, exchange, license, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business*".[43] "Goods" in turn are defined under the CGST Act to mean "*every kind of movable property other than money and securities but includes actionable claim, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before supply or under a contract of supply*"[44].

"Services" on the other hand are defined to mean "*anything other than goods, money and securities but includes activities relating to the use of money or its conversion by cash or by any other mode, from one form, currency or denomination, to another form, currency or denomination for which a separate consideration is charged*"[45].

Accordingly, the first assessment required in this regard is to determine whether cryptocurrencies qualify as "goods" under the CGST Act. The definition of "goods" has a wide import and means all kinds of "moveable property". Several landmark judgments[46] have extensively discussed the scope of "goods" and identified tests that may be employed to ascertain if something qualifies within its ambit. These tests include establishing attributes such as the capability of being in and sold, the existence of an inherent value or utility; and the ability of being transmitted, transferred, delivered, stored, and possessed. It is also settled position that intangibles fall within the ambit of "goods" and more specifically, under the scope of "moveable property".[47] Cryptocurrencies have been viewed as intangible property in several other jurisdictions too.[48] Even in the Indian context, given that cryptocurrencies can be argued to meet the test laid down by the Apex Court, there is merit to the argument that they qualify as goods for the purpose of the CGST Act.

The definition of "goods" also has certain explicit exceptions in the form of "money" and "securities". The CGST Act defines money in an exhaustive manner**. It means the Indian legal tender or any foreign currency, cheque, promissory note, bill of exchange, letter of credit, draft, pay order, traveller cheque, money order, postal or electronic remittance or any other instrument recognised by the RBI when used as a consideration to** settle an obligation or exchange with Indian legal tender of another denomination but shall not include any currency that is held for its numismatic value.[49] In order to qualify as "money" and hence outside the ambit of "goods", cryptocurrency must qualify under one of the given heads.

Legal tender is the first of the categories mentioned in this definition of "money". It may be defined as currency that the sovereign has decreed which ought to be accepted in payment of debts.[50] For instance, every bank note is a legal tender at any place in India, in payment or on account for the amount expressed therein and is guaranteed by the Central Government.[51] Coins are minted at the mints established by the Central Government.[52] Such issued coins too are a legal tender depending on their denomination and the sum payable.[53] The RBI has time and again cautioned[54] users, holders and traders of cryptocurrencies including Bitcoins

[43] Central Goods and Services Tax Act, 2017, Section 7.
[44] Central Goods and Services Tax Act, 2017, clause (52) of Section 2.
[45] Central Goods and Services Tax Act, 2017, clause (102) of Section 2.
[46] *The State of Madras v. Gannon Dunkerley & Co.*; *Sunrise Associates v. Govt. of NCT of Delhi and Ors.*, (2006) 5 SCC 603; *Vikas Sales Corporation AIR 1996 SC 2082*; *Yasha Overseas v. Commissioner of Sales Tax* 2015 (322) E.L.T. 7 (S.C.).
[47] *Tata Consultancy Services v. State of Andhra Pradesh* (2005) 1 SCC 308 (SC); *A.V. Meiyappan v. Commissioner of Commercial Sales* AIR 1969 Mad 284.
[48] Note 21 *supra*.
[49] CGST Act, clause (75) of section 2.
[50] Stephen T. Middlebrook and Sarah Jane Hughes, "*Substitutes for Legal Tender: Lessons from History for the Regulation of Virtual Currencies*, Research Handbook on Electronic Commerce Law" (John A. Rothchild, ed. 2016), Research Paper Number 316, available on SSRN at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2605847>.
[51] Reserve Bank of India Act, 1934, Section 26.
[52] The Coinage Act, 2011, Section 3 and Section 4.
[53] The Coinage Act, 2011, sub-section (1) of Section 6.
[54] RBI Press Releases: 2017-2018/1530 dated 5 December 2017; 2016-17/2054 dated 1 February 2017, 2013-2014/1261 dated 24 December 2013.

regarding the potential economic, financial, operational, legal, customer protection and security related risks associated in dealing with cryptocurrencies. It has clarified that cryptocurrencies are not legal tender and that it has not authorized or licensed any platform to deal with them.[55] A similar clarification was also made by the Union Finance Secretary.[56]

The second category under the definition of "money" is "foreign currency" which, as discussed in the income tax section of this Chapter, is defined under the FEMA to mean any currency other than Indian currency. This thus makes the definition of "money" dependent on how other nations chose to classify cryptocurrencies. For instance, El Salvador officially adopted Bitcoin as legal tender making it a means of exchange for goods and services in the country.[57] Therefore there may be scope to argue that Bitcoin may qualify within the scope of "money" for the purposes of the GST framework and be outside the ambit of "money" even though this interpretation seems to be against legislative intent.

Another possible argument to qualify cryptocurrencies as money may be that cryptocurrencies are in the nature of electronic remittance which a specific category under the GST definition. Given that the phrase "electronic remittance is not defined anywhere, this argument merits further consideration. However, in the definition of "money" the phrase electronic remittance is followed by "…or any other instrument recognised by the RBI when used as a consideration to settle an obligation or exchange with Indian legal tender of another denomination…". It is plausible to argue that in order for electronic remittances to qualify as "money" under the GST framework, they need to be "recognized by the RBI". In this regard, reliance may be placed on the case of ***Mohd. Shabir v. State of Maharashtra***[58], *where* the Court was deciding whether mere stocking of a drug was liable for punishment under the Section 27 of the Drugs and Cosmetics Act, 1940. Relevant portion of Section 27(1)(a) of the said Act read as under:

27. Penalty for manufacturer, sale, etc., of drugs in contravention of this Chapter. *—Whoever, himself or by any other person on his behalf, manufactures for sale or for distribution, or sells, or stocks or exhibits or offers for sale or distributes, —*

The Court held that the absence of any comma after the word stocks clearly indicates that the clause "stocks or exhibits for sale" is one indivisible whole and it contemplates not merely stocking the drugs but stocking the drugs for the purpose of sale and unless all the ingredients of this category are satisfied, Section 27 of the Act would not be attracted. In the definition of money under the CGST Act, there is no comma before the qualification as to recognition by the RBI. Therefore, RBI's recognition would be required if cryptocurrencies are sought to be categorized as "electronic remittances" or as "any other instrument".

Based on this analysis, it appears that cryptocurrencies do not squarely qualify as Indian tender, foreign currency, or any of the other terms listed under the present definition of "money". Hence, it is plausible to argue that they do not fall under the exclusion of the definition of "goods". A similar conclusion was also arrived at by the Australian tax authorities for the purposes of the Australian GST Act.[59]

That said, this interpretation is yet to be tested in court. The concept of "money" or "currency" has changed over the years. The existing laws were written without contemplating technological advancements such as cryptocurrencies. One may argue that given their status as a means for payment, cryptocurrencies fall under one of the items listed under the definition of "money" under the CGST Act. While it did not conclusively rule on this point, the Supreme Court in the case of ***Internet and Mobile Association of India v. Reserve Bank*** of India stated

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[55] Reserve Bank of India, Press Release "*RBI cautions users of Virtual Currencies against Risks*" (December 24, 2013) available at <https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=30247> [Last accessed March, 2022].

[56] *Cryptocurrency will never be a legal tender, says Finance Secretary*, The Tribune dated 3 February 2022, available at <https://www.tribuneindia.com/news/business/cryptocurrency-will-never-be-a-legal-tender-says-finance-secretary-366931#:~:text=Cryptocurrency%20will%20never%20be%20a%20legal%20tender%2C%20Finance%20Secretary%20TV,digital%20currencies%20in%20the%20market.>.

[57] Euronews, updated on 9 September 2021, available at <https://www.euronews.com/next/2021/09/07/el-salvador-makes-history-as-bitcoin-is-officially-adopted-as-a-currency-but-not-without-i>

[58] *Mohd. Shabir v. State of Maharashtra* (1979) 1 Supreme Court Cases 568.

[59] Goods and Services Tax Ruling GSTR 2014/3, Goods and services tax: the GST implications of transactions involving bitcoin, Australian Taxation Office, The Government of Australia, available at <https://www.ato.gov.au/law/view/document?locid=%27CGR/GSTR2014EC3/NAT/ATO/00001%27&PiT=99991231235958> [Last accessed March, 2022].

that "*....it is not possible to accept the contention of the Petitioners that virtual currencies are just goods/commodities and can never be regarded as real money*".

The concept of "money" as stipulated under the CGST Act appears to be broader than just legal tender and currency. There are also significant differences between the definition of "money" under the CGST Act, and the one under the erstwhile service tax laws. The Finance Act, 1992 defined "money" to mean "*legal tender, cheque, promissory note, bill of exchange, letter of credit, draft, pay order, traveler cheque, money order, postal or electronic remittance or any such similar instrument but shall not include any currency*"[60] This definition under the erstwhile law left scope for the inclusion of other instruments under the ambit of money. This phrasing is not present under the CGST Act. While the Supreme Court in this landmark judgment held that cryptocurrencies do not qualify as legal tender, there may still be scope to argue that they fall under the broader ambit of "money". The European Court of Justice ("**ECJ**") in the case of ***Skatteverket v. David Hedqvist*** also deemed cryptocurrencies to be a "means of payment" and treated them at par with legal tender.[61]

The classification of cryptocurrencies for GST purposes will remain ambiguous and uncertain in the absence of any clarification by the Central Board of Indirect Taxes ("**CBIC**"). The implications of this uncertainty are also substantial given that the inclusion of cryptocurrencies under the ambit of "money" will essentially exclude the applicability of GST on transactions such as their exchange for fiat currency.

[60] Finance Act, 1992, clause (33) of Section 65B.
[61] *Skatteverket v. David Hedqvist*, C-264/14 (22 October 2015).

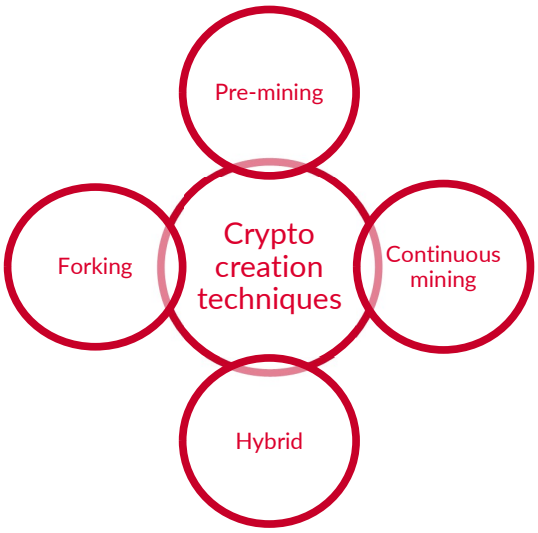
C. Taxable Events

The occurrence of an event that gives rise to tax liability is typically defined as a taxable event. Identifying a taxable event is therefore of paramount Importance when assessing the tax liability of a transaction. In the cryptocurrency ecosystem, there are several events that may potentially qualify as taxable events. This section of the working paper identifies these events. It divides these events into three primary categories, - (i) the creation of cryptocurrencies; (ii) the initial distribution or acquisition of new tokens; (iii) and the subsequent trading, transfer or disposal of these tokens.

1. Creation of cryptocurrencies

One set of crucial events in the cryptocurrency ecosystem is the creation of a particular type of cryptocurrency. Cryptocurrencies can, in theory, be created by any individual, group of individuals, or entity that has been granted access to the data layer (i.e., where the applications run) of a given distributed ledger technology system.[62]

Creation of new tokens takes place in three potential ways. First, there may be situations where the coin inventors[63] create all token units in one batch as a one-time event.[64] This is called a "pre-mine".[65] Second, there could be cryptocurrencies that work on the "continuous mining" model where nodes[66] create new units on a continuous and regular basis according to a transparent, pre-specified procedure specified by the protocol that governs the network or application ruleset.[67] Third, a hybrid model may be employed wherein a specific proportion of the total final token supply is pre-mined while the rest of the token units are then "minted" through continuous mining after network or application launch.[68]



The creation of new units or minting under the continuous mining model and the hybrid model may further be conducted through different consensus mechanisms. While several such consensus mechanisms exist, this working paper discusses the two most popular ones. A proof of work system is the oldest consensus mechanism and is based on mathematical equations, typically hard to solve but whose solutions can be easily checked. Solving the mathematical problem involves computational efforts – resulting in high energy consumption, whereby each validator (called a 'miner') makes calculations to verify the transaction and share their results with the network, working on a competitive basis since a reward is credited to the miner who finds the solution first.

[62] Apolline Blandin, Ann Sofie Cloots & Ors. "*Global Cryptoasset Regulatory Landscape Study*", Cambridge Centre for Alternative Finance available at <https://www.jbs.cam.ac.uk/wp-content/uploads/2020/08/2019-04-ccaf-global-cryptoasset-regulatory-landscape-study.pdf> [Last accessed January, 2022].
[63] Coin inventors are individuals or organizations who have developed the technical foundations of a cryptocurrency and set the initial rules for its use. *See* "Cryptocurrencies and blockchain: Legal context and implications for financial crime, money laundering and tax evasion", Policy Department for Economic, Scientific and Quality of Life Policies (July, 2018) available at <https://www.europarl.europa.eu/cmsdata/150761/TAX3%20Study%20on%20cryptocurrencies%20and%20blockchain.pdf> last accessed March, 2022.
[64] Note 62 *supra*.
[65] *ibid*.
[66] Cryptocurrencies involve sharing data across multiple data stores (ledgers), which each have the exact same data records and are collectively maintained and controlled by a distributed network of computer servers/devices. These serves/devices are called nodes (World Bank (2019), Distributed Ledger Technology (DLT) and blockchain.
[67] Note 62 *supra*.
[68] *ibid*.

Proof of work is for instance used with the Bitcoin blockchain.[69] Upon solving the equation, miners may be entitled to (i) a mining reward (also knowns as the block reward), paid through new tokens, and/or (ii) a protocol transaction fee (also known as the gas fee), which is a percentage of the value of the transaction being processed and is paid from that transaction.[70]

A more upcoming mechanism that became popular as an energy efficient alternative of the proof of work system is the proof of stake system. This system assigns shares of validation rights to users according to the stake they have in the blockchain. In such a system, validators are not called miners – but 'forgers' or 'stakers'. Stakes can be measured differently (number of tokens owned, holding period, amount of assets locked in the blockchain as collateral). Forgers or stakers must have a minimum stake in the blockchain to be able to participate in the verification process: they 'stake' their own tokens to have the right to verify a transaction, and are credited a transaction fee or new tokens. No mathematical equations are therefore required to verify a transaction.[71] Hence, unlike the proof-of-work protocol, the nodes do not validate transactions using computing power. Instead, the coins with an active node are staked on the blockchain. If the node operator either fails to validate properly, or fraudulently tries to validate an incorrect transaction that is not agreed to by the other nodes, then they are penalized financially against their stake.[72] Given that the proof-of-stake mechanism is a lot more energy efficient when compared to its counterpart, the cryptocurrency community seems to be moving towards its adoption. In a historic move, the Ethereum decided to switch from the proof-of-work model to the proof-of-stake model.[73] The incentive granted to nodes for staking is similar to that granted under the proof-of-work model i.e. (i) a block reward "paid" by the network through creating new coins; and (ii) transaction-incentive, paid by the initiator of the transaction to encourage nodes to verify his or her transaction.[74]

Another noteworthy concept that is a by-product of mining and staking, though somewhat unrelated to the initial distribution and acquisition of cryptocurrencies, is the dilution effect. Dilution can be described as the loss suffered by incumbent owners of a value unit (such as a coin) at the time new value units are created for instance for the payment of a block reward.[75] Dilution leads, all things being equal, to a decrease in fair market value of all existing value units.[76]

A new cryptocurrency may also come into existence as a result of an incompatible rule change in the underlying distributed ledger technology system that causes the network to split.[77] In such cases, a new version of the blockchain alongside the old version is created, bringing into existence a new token which operates under the rules of the amended protocol while the original token continues to operate under the existing protocol.[78] This is termed as a 'hard fork', or 'forking', or a 'chain split'. A hard fork in the Bitcoin distributed ledger technology system in 2017 led to the creation of Bitcoin Cash.[79]

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[69] Note 21 *supra.*
[70] *Ibid.*
[71] *ibid.*
[72] PwC Annual Global Crypto Tax Report 2021 (December 2021) available at <https://thesuite.pwc.com/insights/pwc-annual-global-crypto-tax-report-2021> [Last accessed February, 2022}.
[73] Yvonne Lau, "*Ethereum founder Vitalik Buterin says long-awaited shift to 'proof-of-stake' could solve environmental woes*", Fortune Magazine (May 27, 2021), available at <https://fortune.com/2021/05/27/ethereum-founder-vitalik-buterin-proof-of-stake-environment-carbon/>.
[74] PwC Annual Global Crypto Tax Report 2021 (December 2021) available at <https://thesuite.pwc.com/insights/pwc-annual-global-crypto-tax-report-2021> [Last accessed February, 2022].
[75] PwC Annual Global Crypto Tax Report 2021 (December 2021) available at <https://thesuite.pwc.com/insights/pwc-annual-global-crypto-tax-report-2021> [Last accessed February, 2022].
[76] PwC Annual Global Crypto Tax Report 2021 (December 2021) available at <https://thesuite.pwc.com/insights/pwc-annual-global-crypto-tax-report-2021> [Last accessed February, 2022].
[77] Note 62 *supra*.
[78] Note 21 *supra.*
[79] Note 62 *supra*.

1.1. Income-tax implications at the time of creation of cryptocurrencies

1.1.1. Before Financial Year 2022-23

As set out in the preceding sections of the working paper, cryptocurrency transactions prior to Financial Year 2022-23 are likely to be taxed as capital gains or business income, depending on whether a person is engaged in the business of cryptocurrency or not. This argument further finds support in the official statement made by the chairman of the Central Board of Direct Taxes, J. B. Mohapatra, in a post Budget interview wherein he clarified that *"cryptocurrency transactions before 1st April 2022 will not be tax-neutral and will be assessed based on the tax returns filed by the taxpayers"*[80].

At the outset, the term 'business' has been defined in a broad and inclusive manner under the IT Act and it includes "*any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture*". In the landmark judgement of ***Barendra Prasad Roy v. ITO***, the Supreme Court held that "*the word business is one of wide import and it means an activity carried on continuously and systematically by a person through the application of his labour or skill with a view to earning an income*".[81] Accordingly, applying the same rationale for cryptocurrencies, the income tax authorities may determine the nature of a transaction based on the manner of maintaining books of account, the magnitude of purchases and sales and the ratio between purchases and sales, holding period, the motive of earning a profit etc.[82]

Mining of cryptocurrencies: When a miner solves a particular cryptographic problem, then such miner is credited with unit(s) of cryptocurrency by the blockchain software as a reward. Now, where the miner is engaged in the business of providing mining services, such reward might be taxable as business income in the hands of the miner. Hence, the total income of a miner accruing from mining services shall be taxable at the rate of 30 per cent. This will intrinsically require a valuation mechanism. Further, any expenses incurred by the miner while mining such as electricity costs might be tax deductible as business expenses.[83] Additionally, any transaction fee received by the miner may also be taxed as business income.

However, if mining is carried out as a casual activity or a hobby, an evaluation would be required whether the rewarded cryptocurrency would be characterized as ordinary income and taxed under the head "income from other sources" or as a non-taxable capital receipt. For it to be characterized as other income, the relevant test would be whether cryptocurrency falls within the ambit of the term "property"[84] as receipt of a "property" for nil or inadequate consideration triggers a taxable event for the recipient under IT Act.[85] Though, given the Finance Act 2022-23 includes VDAs as a separate class under the extant definition of "property", it is likely that cryptocurrency will not qualify as property prior to Financial Year 2022-23.

Staking of cryptocurrencies: When a user stakes his units to validate a new block, new cryptocurrency units are minted and distributed as staking rewards to that block's validator. The receipt of such rewards might be taxable in the hands of the validator as business income provided the user held cryptocurrency units staked by him as stock-in-trade. Reliance can be placed in this regard on the case of ***Commissioner of income-tax v. Neha Builders***[86] wherein the High Court of Gujarat while adjudicating upon whether rental income earned on property owned by a real estate developer would constitute as business income or income from house property held that *"if the*

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[80] "*Investing in crypto? Transactions done before April 2022 won't be tax free*", Livemint (3 February 2022), available at < <https://www.livemint.com/news/india/investing-in-crypto-transactions-done-before-april-2022-won-t-be-tax-free-read-here-11643877632544.html>[Last accessed February 2022].
[81] [1981] 129 ITR 295 (SC).
[82] Central Board of Direct Taxes, Circular No. 4/2007 dated 15 June 2007.
[83] Income-tax Act, 1961, Section 37.
[84] The term "property" is defined under Section 56 as "*any capital asset of the assesse being immoveable property being land, building or both, shares and securities, jewelry, archaeological collections, drawings, paintings, sculptures, any work of art or bullion*".
[85] Income-tax Act, 1961, clause (x) of sub-section (2) of Section 56.
[86] (2008) 296 ITR 661 (Guj).

property is used as 'stock-in-trade', then the said property would become or partake the character of the stock, and any income derived from the stock would be income from the business."

Further, similar to mining, any expense incurred during staking shall be deductible as business expenses. Though, where a person is not engaged in the business of cryptocurrency, the receipt of additional units may be taxable in the hands of the validator in the same manner as mining.

1.1.2. Financial Year 2022-23 onwards

The Finance Act, 2022 inserted Section 115BBH that taxes transfer of VDAs at 30% w.e.f. 1 April 2022.[87] The trigger for tax is therefore transfer. As per section 115BBH of the IT Act, no deductions other than cost of acquisition shall be available and no carry forward or set-off of loss of or against the income from transfer from VDA will be available. Therefore, it can be argued that transfer of VDA excludes mining and staking.

1.1.3. Challenges to taxing creation of cryptocurrencies

In case of Bitcoin or Ethereum that operates on the proof-of-work or proof-of-stake model, when a user writes and signs a transaction, miners validate the transaction and provide security to the transactional data stored in the blockchain. They do so with powerful computational hardware, which they use to solve complex computational puzzles. A mining reward, sometimes in the form of coins is paid to these miners and stakers. The coins are not paid by an entity but are won on the network. Therefore, there is no transferor per se. Therefore, there is lack of clarity on whether the term 'transfer' would include the activity of mining and staking cryptocurrency.

1.2. GST implications at the time of creation

1.2.1. Mining and staking of cryptocurrencies

Mining and staking of cryptocurrencies typically involve the receipt of tokens by nodes in the form of a) block rewards; and b) transaction fee. One may argue that mining and staking are hence at par with the provision of any other service in exchange for receipt of cryptocurrencies and should be treated as such in the manner discussed above. While this *prima facie* may appear to be a fair argument, it involves several layers of complexities that come into play regardless of whether cryptocurrencies are classified as goods or services.

It is plausible to argue that transactions involving the receipt of cryptocurrencies through activities such as mining and staking, do not amount to a supply. It is undeniable that the nodes conducting mining and staking activities add great value to the functioning of the cryptocurrency is question. Not only do they provide a degree of security to the network, but they play a critical role in the functioning of the system by validating transactions. The tax authorities of several jurisdictions including the UK[88] and many EU nations[89] believe that there needs to be a direct link between the services supplied and the consideration received, as well as a reciprocal performance between the provider of the service and the recipient in order to justify a GST levy. It is believed by these jurisdictions that such a link may not exist between the nodes and the concerned cryptocurrency's system, or the persons making transaction validation requests.

In light of the above, it is relevant to determine if the Indian GST framework also requires a "link" to be present between the service and the consideration, and if so, does the link exist in this case. The phrase "in respect of, in response to, or for the inducement of" which is present in both sub-clauses of the definition of consideration[90]

[87] Finance Bill, 2022, Section 28.
[88] Government of UK, HMRC internal manual: VAT Finance Manual available at <https://www.gov.uk/hmrc-internal-manuals/vat-finance-manual/vatfin2330> [Last accessed March, 2022].
[89] Note 89 *supra.*
[90] Central Goods and Services Tax Act, 2017, clause of (31) of Section 2.

suggests the need for a link between the consideration and the supply of services. This requirement for a nexus between consideration and supply also draws from the aforementioned definition of supply which uses the phrase "supply for consideration".[91] However, when compared with the language used in other jurisdictions, it can be contended that the Indian framework does not necessarily require a direct link. As the term consideration is not defined either in the UK or any of the EU states' statutes, the ECJ has held that it is to be given the community meaning which has been taken from the EC 2nd VAT Directive Annex A13 which defines consideration to mean *"everything received in return for the supply of goods or the provision of services"*.[92]

The phrase "in return for the supply" has been interpreted to suggest a direct link between the supply and the consideration. The case of ***Staatssecretaries van Financien***[93] for instance, involved a co-operative providing cold storage facilities to its members who had the right to store potatoes because of the share each member held in the co-operative. Charges were normally made to the members for the storage but for two consecutive years no charges were made. This resulted in a drop in the value of the shares (reflecting the cooperative's reduced profits because of the lack of storage fee income). The Dutch tax authorities argued that the reduction in value of each member's share was effectively consideration for the storage which had been provided for no fee. The ECJ rejected this argument. It was held that there is no direct link between the services of storage and the decrease in share values. Additionally, the reduction in value of the shares could not be equated directly to the cost or any other measure of the value of the services provided.

Similarly, in the ***Apple & Pear Development Council case***[94] the Council was a statutory body, formed to promote the sale of apples and pears. Commercial growers were required to register with the council and pay an annual levy. The industry as a whole received the benefit of its promotional activities. The point in question was whether the levy was consideration for the promotional activities. The ECJ held that there was no direct link between the supply made and the "payment" received, that is benefit, was not directly related to payments made, and individual growers were obliged to pay the levy, regardless of whether they benefited. The decision was based on the following factors: the benefits of the Council's services accrued to the whole industry; there was no relationship between the level of benefits which individual growers obtained and the amount of charges they were obliged to pay; the charges were always recoverable from each grower as a debt due to APDC regardless of whether or not a given service conferred a benefit to them.

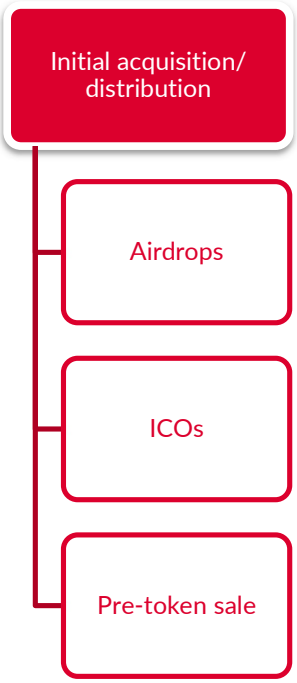
The degree of this link or connection required under various VAT/GST statutes has been debated often and a distinction has been drawn between the text used in the EU and UK; and the laws applicable in New Zealand and Australia. As opposed to the 'direct nexus' test required by the laws in the EU and the UK, the Australian law and the law in New Zealand requires a 'sufficient nexus' or a 'substantial connection' between a supply and its consideration.[95] The test of sufficient or substantial connection is wider and has brought a larger range of cases within its sweep as compared to the direct test.[96]

Based on the use of the phrase "in respect of, in response to, or for the inducement of" in both sub-clauses of the definition of consideration,[97] it is plausible to argue that it employs the "sufficient nexus test". To this extent, it is thus different from the EU and UK approach and more like the Australia and New Zealand one. In such cases, in determining whether a sufficient nexus exists between supply and consideration, it has been held that regard needs to be had to the true character of the transaction. An arrangement between parties is to be characterised not merely by the description that parties give to the arrangement, but by looking at all of the transactions entered into and the circumstances in which the transactions are made. The test as to whether there is a sufficient nexus is therefore an objective test. The motive of the supplier and the recipient also may be relevant in determining whether the supply was made for consideration, if a reasonable assessment of the evidence

[91] Central Goods and Services Tax Act, 2017, Section 7.
[92] Government of UK, HMRC internal manual: VAT Finance Manual available at <https://www.gov.uk/hmrc-internal-manuals/vat-finance-manual/vatfin2330> [Last accessed March, 2022].
[93] *Staatssecretaries van Financien v. Cooperatieve Aardapplenbewarrplaats* ((1981) ECR 445; (1981) 2 CMLR 337).
[94] *Apple & Pear Development Council (APDC)*, (ECJ (1988) STC 221; (1988)2 CMLR 394).
[95] *Berry v. FC of T* (1953) 89 CLR 653.
[96] Goods and Services Tax Ruling GSTR 2001/6 available at <https://www.ato.gov.au/law/view/document?Docid=GST/GSTR20016/NAT/ATO/00001> [Last accessed March, 2022].
[97] Central Goods and Services Tax Act, 2017, clause of (31) of Section 2.

supports that motive.[98] In the case of mining and staking of cryptocurrencies, it is clear that the activities of the nodes add value to the cryptocurrency system. It may also be argued that there is indeed a link between the activity conducted by the nodes and the cryptocurrency they receive. However, to determine whether the link is "sufficient', the situation will need to be assessed on a case-by-case basis. Factors such as the respective cryptocurrencies' protocols regarding payment and whether such payment is voluntary or mandatory may play a significant role in determining whether a transaction is leviable to GST. If mining and staking are indeed found to be taxable, ascertaining the location of the recipient of the service will also be a substantial challenge.

2. Initial distribution or acquisition of cryptocurrencies



Once a cryptocurrency is created, it can be initially acquired or distributed through several methods. One such method is a pre-token sale which is a private round offering of pre-mined token units, often at substantial discounts. Pre-token sales are generally restricted to accredited investors. Often at the time of these sales the network or application is not even operational, and acquisition of a token comes with conditions such as lock-in periods. If the network or application is not operational at the time of the sale, the distributed tokens generally represent a claim on the future delivery of operational tokens that can be used on the network/application once it becomes operational.[99] Cryptocurrencies such as Telegram and Kin were initially distributed through pre-token sales.[100]

The initial distribution of tokens can also be conducted through Initial Coin Offerings ("**ICOs**", also often called Initial Token Offerings). ICOs effectively allow coin inventors to raise capital for their projects, by issuing digital tokens in exchange for fiat currencies or other cryptocurrencies.[101] Such offerings may be private or public offerings of tokens and may even be made at a time when the network/application may not be operational yet.[102] ICOs are typically promoted on the web and social media to potential investors using 'white papers'. Some digital platforms have even specialised in the promotion of ICOs.[103] ICOs have typically been used to distribute utility tokens, rather than virtual currencies.[104] Several regulatory agencies across the globe including the United States' Securities and Exchange Commission have attempted to regulate and, in some cases, even ban ICOs, which has deemed them to be a less frequent means of distributing new tokens.[105] Examples of cryptocurrencies distributed through ICOs include Tezos and Bancor.

New token units are also often distributed to holders of an existing other token, generally under specific conditions and this process is called an Airdrop. [106] Airdrops are usually done without compensation (i.e. for free), generally with a view to increasing awareness of a new token, particularly amongst "influencers", and to increase

[98] Note 96 *supra*.
[99] Note 62 *supra*.
[100] *ibid*.
[101] European Securities and Market Authority, Advice Initial Coin Offerings and Crypto-Assets, 9 January 2019, < https://www.esma.eu0072opa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf>
[102] Note 62 *supra*.
[103] European Securities and Market Authority, Advice Initial Coin Offerings and Crypto-Assets, 9 January 2019, <https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf>.
[104] Note 21 *supra*.
[105] ibid.
[106] Note 62 *supra*.

liquidity in the early stages of a new token project.[107] Examples of cryptocurrencies where this process has been deployed for initial distribution include Stellar Lumen and Decred.[108]

As noted briefly in the previous section, forking is an event that leads to the creation of a new cryptocurrency when there is an incompatible rule change in the distributed ledger technology system causing a split. In such cases too, there is a mechanism of distribution of the new cryptocurrency that comes into existence. These new tokens are distributed to existing token holders typically on a 1:1 ratio basis.[109]

2.1. Income-tax implications at the time of initial acquisition or distribution of cryptocurrencies

2.1.1. Before Financial Year 2022-23

When a person engaged in the trade of cryptocurrency acquires new units without any consideration such as through **airdrops** or a **hard fork** and the units so acquired are either not marketable or do not have an underlying value, then the receipt of the new units should ideally be tax neutral in the hands of such person. For instance, in a recent case[110] the Mumbai Tribunal while adjudicating upon the scope of CBDT circular dated 1 August 2012 clarified that any free samples of medicines received by doctors with the intention of marketing and establishing the trust of the doctors cannot be equated to receipt of freebies and is accordingly not taxable as business income in the hands of the doctors. However, where the cryptocurrencies are marketable and have an underlying value then the receipt will be taxable as business income.

Where cryptocurrencies are distributed to a person not engaged in the trade of cryptocurrency and the units so acquired are either not marketable or do not have an underlying value, then the receipt of the new units should ideally be tax neutral in the hands of such person. This is based on the rationale that such units will not hold any value for the acquirer and thereby not constitute as income. Even if the units are marketable, it can be argued that receipt of cryptocurrency is not taxable under the head "income from other sources", since it cryptocurrencies were not included within the ambit of "property".

Separately, when a person engaged in the trade of cryptocurrency acquires new units with consideration and the units so acquired have an underlying value, such as through **ICOs**, then the acquisition of new units in the nature of stock-in trade would be tax neutral. Similarly, where the cryptocurrencies are distributed to a person not engaged in the trade of cryptocurrency, then such units in the form of investment should not be taxable at the time of acquisition.

The distributors of cryptocurrencies should be allowed to claim the value of the distributed units as a business expense. Reliance in this regard can be placed on the judgement of the High Court of Delhi in the case of ***Nokia India Pvt. Ltd. V. ACIT***[111] wherein it was affirmed that distribution of free mobile handsets by the taxpayer engaged in manufacture and sale of such handsets as a form of marketing was rightly accounted for as business expenditure.

[107] Note 21 *supra*.
[108] Note 62 *supra*.
[109] *ibid*.
[110] *ACIT v. Solvay Pharma India Ltd* (ITA No. 1922/Mum/2019).
[111] ITA No. 955/2018.

2.1.2. *Financial Year 2022-23 onwards*

Irrespective of whether:

a) the receiver of cryptocurrency is engaged in the activity of trading of currency or not;
b) the VDA was acquired by such person with or without a consideration or not;
c) the VDA received is marketable or not,

acquisition of a VDA does not result in disposal or parting with a VDA and therefore, it can be argued that acquiring VDAs via airdrops, ICO or pre-token sale does not amount to a transfer and therefore, Section 115BBH is not triggered.

2.1.3. *Challenge*

As discussed earlier, Section 115BBH of the IT Act, which came into force on 01 April 2022, seeks to tax all transfers of virtual digital assets at 30 percent. This means that initial acquisition or distribution of VDAs is taxable at a flat rate of 30 per cent. A 30 per cent rate of tax on transfers coupled with disallowance of any expenses apart from cost and disallowance of set or carry forward of loss on cryptocurrencies is a high rate. The taxation regime adopted for cryptocurrencies thus puts it at par with tax on winning from horse races, betting and speculation. The intention of the government seems to be to disincentivize speculative trading in cryptocurrency. This approach is problematic as taxes should not be distortionary in as much it should not be used as a tool to disrupt industries.

2.2. *GST implications at the time of initial distribution or acquisition of cryptocurrencies*

GST implications only arise when goods or services are received in exchange for consideration. Many of the methods of initial acquisition of cryptocurrencies discussed in this section such as airdrops do not involve any consideration. It may be argued that typically airdrops are available due to past engagement in the crypto ecosystem, given the ad-hoc and voluntary nature of these transactions, any link between such engagement and the receipt of cryptocurrencies would be difficult to demonstrate. The GST implications therefore only arise when cryptocurrency is acquired in exchange for fiat currency, or other goods or services. This treatment will remain the same regardless of whether the transaction constitutes the initial acquisition or subsequent transfers (in the secondary market) of cryptocurrency in exchange for fiat currency or goods or services.

Exchange of cryptocurrencies for fiat currency: Transactions in money are outside the scope of the GST framework by virtue of the exclusion of "money" from the scope of "goods" and "services". Therefore, if cryptocurrencies are construed to qualify as "money" for the purpose of the CGST Act, a transaction that only concerns their exchange for fiat currency, or even their exchange for other cryptocurrencies without any additional consideration (such as commission or exchange fee), the same will fall outside the scope of the GST framework. This could arguably include ICOs or pre-mine sales where acquirers pay a certain sum of money in exchange for new tokens.

Alternatively, if cryptocurrencies are considered to qualify as "goods" which appears to be a more plausible conclusion under the existing framework of the CGST Act, several GST implications will ensue. Once a supply of goods or services for consideration has been established, it becomes relevant to assess whether the exchange is i) conducted in the course of furtherance of business; and ii) if it is non-taxable under any other exemption of zero-rating provision.

While discerning whether exchange of cryptocurrencies for fiat currency is conducted in the course of furtherance of business, the status of the persons involved will be relevant. The term "business" is given an extremely wide import under the CGST Act and includes any trade, commerce, manufacture, profession,

vocation, adventure, wager or any other similar activity, whether or not it is for a pecuniary benefit.[112] A Press Release issued by the CBIC sheds some light on what is considered to be an activity not in the course of furtherance of business. It analysed whether the sale of gold jewelry by a consumer of gold accounts to a supply and reached the conclusion that such a sale "*cannot be said to be in the course or furtherance of his business (as selling old gold jewelry is not the business of the said individual)*".[113]

Applying the same logic for cryptocurrencies, it may be argued that even if their exchange is thought to be under the scope of the GST framework, it will not attract GST so long as the activity is not conducted in the furtherance of business. Accordingly, for instance if an individual or even a business purchases cryptocurrencies as a speculative investment, no GST will be levied when they choose to sell their cryptocurrencies. If such a sale is conducted for instance by a crypto trader or a crypto wallet, it will be leviable to GST. In that case, further assessment will be necessary to determine whether the transaction in question is zero rated or exempt. This assessment will need to be conducted for each supply in light of the specific fact pattern. Given the nature of transactions in the cryptocurrency ecosystem however there is an added layer of complexity involved. For instance, export of goods is a zero-rated supply under the GST framework.[114] A transaction qualifies as a supply if goods are taken out of India.[115] Notably, this concept of export is very heavily reliant on the physical location of goods and was not contemplated to apply to transactions such as transfer of cryptocurrencies. The application of the provisions that relate to the place of supply of goods to the current scenario is hence questionable. The provisions as they stand today are not adept to apply to situations where for example the sale of cryptocurrency for fiat currency is made by an Indian resident to someone outside India. To add to the complexity, given the decentralized nature of cryptocurrencies and the degree of anonymity associated with crypto developers, there may also be cases where there is no way to ascertain a single location for parties to a transaction. For instance, in cases of ICOs or pre-mine sales where tokens are acquired for money, there may be no way to establish a location for the suppliers.

Exchange of cryptocurrencies for other goods or services: In such cases also, there will be two fundamentally different treatments depending on how cryptocurrencies are classified. If they are treated as "money", the applicability of GST on the transaction will largely depend on the nature of the goods and services in question. Given that cryptocurrencies in such cases are merely a means of exchange, their use for procuring taxable goods or services would be taxed the same as the supply of such goods or services for money would be treated.

Alternatively, if cryptocurrencies are treated as goods, their use for the procurement of other goods and services (including other cryptocurrencies) will be treated like a barter transaction. The definition of "supply" under the CGST Act specifically includes barter transactions within its ambit.[116] Even the definition of "consideration" is wide and includes "any payment made or to be made, whether in money or otherwise".[117] There are also valuation provisions under the CGST Act that provide a mechanism to value such supplies.[118] Prior to 2017, the Australian GST authorities treated such transactions as barter transactions too.

3. Disposal of cryptocurrencies

Once tokens have been initially acquired by users in the cryptocurrency community, there may be several peer-to-peer transactions in the ecosystem. Cryptocurrencies may be disposed for a variety of different considerations. For instance, cryptocurrencies may be exchanged for fiat currency, cash, other cryptocurrencies, or even without any consideration such as when a token is given as a gift, as a part of one's inheritance, or is lost or stolen. The tax implication of these transactions may vary based on the use case. Several factors such as the

[112] Central Goods and Services Tax Act, 2017, clause 17 of Section 2.
[113] Central Board of Indirect Taxes, Press Release: Further clarification on tax in reverse charge on gold ornaments (13 July 2017) available at <https://cbic-gst.gov.in/pdf/press-release/Press-Release-Reverse-Charge.pdf> [Last accessed January, 2022]
[114] Integrated Goods and Services Tax Act, 2017, Section 16.
[115] Integrated Goods and Services Tax Act, 2017, clause (5) Section 2.
[116] Central Goods and Services Tax Act, 2017, Section 7.
[117] Integrated Goods and Services Tax Act, 2017, clause (5) of Section 2.
[118] Central Goods and Services Tax Act, Section 27.

nature of the transaction, the receipt of consideration, if any, the status of the cryptocurrency holder etc. will impact the tax outcome. Each of these use cases will need to be studied against the existing tax framework to assess whether they fit under the current regime, or if further amendments are required to accommodate them.

3.1. Income-tax implications at the time of disposal of cryptocurrencies

3.1.1. Before Financial Year 2022-23

Exchange of cryptocurrencies for fiat currency or other cryptocurrencies: Any income earned through a transaction where a person is engaged in the business of cryptocurrency and holds it as stock-in-trade and subsequently transfers such cryptocurrency in exchange for fiat currency or units of another cryptocurrency, may be taxable as business income. A person would be said to have earned income where the consideration (i.e., value of the fiat currency or the acquired units) exceeds the value of the stock-in trade transferred by such person. However, any income earned through a transaction where a person holds cryptocurrency as a capital asset may be taxable under the head capital gains. Such person shall not be liable to pay tax on the entire sale value but rather on the gain made on such transaction i.e., value of the fiat currency or the units of the other cryptocurrency as reduced by the cost of acquisition of the disposed units.

Exchange of cryptocurrency for goods or services: In a situation where a person holds cryptocurrency as stock-in-trade and barters such stock-in-trade for other goods or services, such person will arguably be subject to tax under the head business income. Reliance in the regard can be placed on a recent judgement of the Delhi High Court in the case of ***Commissioner of income tax v. Nalwa Investment Ltd***.[119] wherein the court adjudicated upon whether extinguishment of shares of the amalgamating company held by the taxpayer as stock-in-trade in lieu of shares of the amalgamated company would be taxable as business income or not. The taxpayer argued that share swaps in the course of an amalgamation are afforded tax neutrality under section 47(vii) of the IT Act and accordingly the transaction should not be taxable. However, the court held that: *"Benefit of tax exemption would have been available if the assessee were to contend that the shares in question were held as capital asset. One cannot ignore the fact that the shares that were with the assessee have undergone the amalgamation process whereby they were replaced with new shares which would be valued entirely on different fundamentals. In such a case, difference between the book value of the shares of the first company and the market value of the shares of the second company as on the date of such realisation will have to be treated as profit earned by the assessee in that transaction and accordingly be taxed as business income."*

Though, where a person does not hold cryptocurrency as stock-in-trade but ordinarily accepts units as form of payment for the procurement of goods/services in business transactions, thereby treating cryptocurrency at par with "money", the exchange of units in lieu of goods or services may be viewed as transfer of a capital asset and capital gains tax may be levied on it. It is pertinent to note that in a reverse situation, where a person provides goods or services and accepts units of cryptocurrency as payment, such payment will amount to the person's business income and would be taxed accordingly. Further, in a situation where a person holds cryptocurrency as capital asset and barters such capital asset for other goods or services, such transaction will amount to transfer within the meaning of section 2(47) of the IT Act. Accordingly, any gains made on such transfer will be subject to capital gains tax.

Gift: Where a person engaged in the business of cryptocurrency receives units of cryptocurrency as a gift, the receipt of such gift may be taxable in the hands of such donee as business income. However, tax may not get triggered where the gifted units are not marketable or don't have an underlying value (*please refer to the tax implications for airdrops set out above*). Alternatively, where a person not engaged in the business of cryptocurrency receives units of cryptocurrency as a gift, it can be argued that the receipt of such gift is not taxable in the hands of the donee as cryptocurrencies were not included within the definition of "property".

[119] ITA 822/2005.

Further, where a person distributes units of cryptocurrency during the course of the business without any consideration, such gifts should be deductible in the hands of the donor as marketing expenses.

3.1.2. Financial Year 2022-23 onwards and Challenges

Exchange of cryptocurrencies for fiat currency or other cryptocurrencies: Any income earned through a transaction where a person is engaged in the business of VDA and holds it as stock-in-trade and subsequently transfers such VDA in exchange for fiat currency or units of another VDA, are taxable under Section 115BBH at a flat rate of 30% plus cesses and surcharges. Such person shall not be liable to pay tax on the entire sale consideration but rather on the gain made on such transaction i.e., value of the fiat currency or the value of units of the other VDA acquired as reduced by the cost of acquisition of the disposed units. The same treatment is accorded if the person transferring the VDAs held the same as investment.

Exchange of cryptocurrency for goods or services: In a situation where a person holds VDAs as stock-in-trade and barters such stock-in-trade for other goods or services, such person will also be required to pay tax as per Section 115BBH. The treatment where a person does not hold VDAs as stock-in-trade but ordinarily accepts units as form of payment for the procurement of goods/services in business transactions, thereby treating VDAs at par with "money", the exchange of VDAs in lieu of goods or services is taxable under Section 115BBH. In cases where a person holds VDAs as investment and barters such VDAs for other goods or services, such transaction will be taxable under Section 115BBH and liable to tax at 30%. In all of the three cases described above, deduction of cost of acquisition will be available from value of transfer of the VDA to arrive at the gain made from such a transfer.

Gift: The Finance Act, 2022 amended the explanation to clause (x) of sub-section (2) of Section 56 to include virtual digital asset or VDA within the scope of the expression "property". Due to this amendment, where a person receives units of a VDA as a gift i.e., without consideration, the receiver of such VDA is liable to pay tax if the aggregate fair market value of the VDAs received exceeds Rs.50,000/-. When a person receives any VDA for a consideration which is less than the fair market value, if the difference between the consideration and the fair market value exceeds Rs.50,000/-, the receiver will be liable to pay tax on the difference.

In cases where cryptocurrencies are exchanged for goods and services or other cryptocurrencies, the absence of a coherent valuation mechanism will lead to disputes.

3.2. GST implications during disposal of cryptocurrencies

Disposal of cryptocurrency when conducted in exchange for fiat currency, or other goods or services will attract the same GST treatment as discussed in Section 2.2.Accordingly, if cryptocurrencies are construed to qualify as "money" for the purpose of the CGST Act, their disposal without any consideration, or for consideration in fiat currency or other cryptocurrencies will fall outside the scope of the GST framework, If cryptocurrencies are construed as "money" and their disposal is for consideration in goods and services, in such cases as discussed in the Section 2.2, the goods and services in question will attract GST as they would when sold for traditional money.

Alternatively, if cryptocurrencies are considered to qualify as "goods", several GST implications will ensue on their disposal regardless of whether the same is for no consideration, for consideration in the form of fiat currency, for consideration in the form of other cryptocurrencies, other goods, or services. If disposal is for consideration of any kind, as discussed in Section 2.2, an assessment into whether the same is i) conducted in the course of furtherance of business; and ii) if it is non-taxable under any other exemption of zero-rating provision and GST will apply accordingly. In cases where the disposal is made without any consideration, other disposals such as disposal as gifts or as a part of one's inheritance etc. do not involve an element of consideration and would hence be outside the scope of the GST law.

D. International Experience

Tax authorities across the world have been grappling with applying their existing tax frameworks to the cryptocurrency ecosystem. While some countries have responded to the challenges of taxing cryptocurrencies by issuing detailed advisories, several other countries have refrained from specifically addressing the issue. This wide range in global practices is partly due to the high degree of complexity associated with taxing cryptocurrencies, and partly due to conscious policy calls taken by each jurisdiction. Certain jurisdictions such as Belarus, El Salvador, Malta, and Hong Kong are particularly encouraging promotion and innovation in the cryptocurrency ecosystem through friendly legislations and substantial tax breaks.[120] In India, several policymakers and regulators have been persistently clamping down on cryptocurrencies.[121] On the tax front however, all transfers involving cryptocurrencies have been brought within the taxation ambit.[122] Before assessing the applicability of India's tax framework on cryptocurrencies, this section of the working paper identifies certain jurisdictions and analyses the guidance issued therein, to apply their tax framework to transactions in cryptocurrencies.

1. Tax on income from cryptocurrencies

1.1. Classification

As noted in the previous section the characterisation of cryptocurrencies is a key step in ascertaining whether they can fit into the existing taxation framework, or if they need to be specifically included. While many countries appear to deem cryptocurrencies as a form of property for tax purposes, some classify it as the international currency, or a legal payment method.[123] The OECD conducted a survey and concluded that cryptocurrencies have been classified by several countries into the following broad categories[124]:

Intangible assets other than goodwill	Financial instrument or asset	Commodity or virtual commodity	Currency	Legal Payment method
Australia, France, Chile, Czech Republic, Luxembourg, Spain, Sweden, Switzerland, and United Kingdom	Argentina, Brazil, Croatia, Denmark, Israel, Japan, Slovak Republic, and South Africa	Austria, Canada, China, and Indonesia	Belgium, Cote d'Ivoire, Italy, and Poland	Japan

While the abovementioned countries have issued guidelines to specifically classify cryptocurrencies into certain buckets, in many of these countries, their classification and hence tax treatment, varies based on the use case.

[120] PwC Annual Global Crypto Tax Report 2021 (December 2021) available at <https://thesuite.pwc.com/insights/pwc-annual-global-crypto-tax-report-2021> [Last accessed February, 2022].
[121] Devansh Sharma, "*RBI's cryptocurrency clampdown: Will existing investors lose their money?*", Economic Times (December 31, 2018) available at <https://economictimes.indiatimes.com/wealth/personal-finance-news/rbi-clamps-down-on-cryptocurrencies-what-will-existing-investors-lose-their-money/articleshow/63640904.cms?from=mdr> [Last accessed January, 2022].
[122] Shishir Sinha, "*Fin Min sees I-T, GST implications in the trade in crypto-currencies*", Hindu Business Line (February 16, 2021) available at <https://www.thehindubusinessline.com/money-and-banking/finmin-sees-i-t-gst-implications-in-the-trade-in-crypto-currencies/article62180390.ece> [Last accessed January, 2022].
[123] Note 21 *supra*.
[124] *ibid*.

For instance, Switzerland considers cryptocurrencies to be a part of "inventory", when companies trading in them are involved in a transaction.[125]

1.2. Taxable event

Once income as cryptocurrencies is classified into a category, the next question that arises is determining the taxable event. As noted in previous sections of this working paper, the taxable event is the point at which liability to pay tax is triggered. A new token may be created or initially acquired or obtained through i) rewards of mining or staking, ii) pre-token sales; iii) ICOs; iv) airdrops; or v) forking. Several jurisdictions such as Croatia, Denmark, Estonia, France, and Poland do not treat the initial acquisition of new tokens through any of the mechanisms identified above to constitute a taxable event.[126] The first taxable event in these countries is thus the disposal of these tokens.

Several countries including Argentina, Austria, Finland, Japan, Luxembourg, New Zealand, South Africa, the United Kingdom and the United States consider initial acquisition of cryptocurrency as the first taxable event in certain circumstances.[127]

In **Australia** for example, the timing of the first taxable event differs depending on whether mining is carried out as part of a business activity or not. If so, any cryptocurrencies generated *via* mining is treated as trading income. The tax framework also allows such businesses to deduct losses made from the business of mining against the taxpayers' other income. At the same time, expenses incurred in respect to the mining activity, including electricity costs, are deductible. In cases where mining is not conducted as part of a business, the mined tokens are not taxed at the time of acquisition at all.[128] The tax treatment of new tokens received as rewards for staking differs from those received from mining. These new units received from staking are treated as taxable income regardless of whether such units are acquired as a part of a business activity or otherwise.[129] In the case of airdrops where new cryptocurrency tokens are usually distributed for free to users, primarily to increase and attract new users, Australian tax authorities treat the initial acquisition of the units to be taxable as ordinary income similar to the receipt of paid-up bonus shares.[130] Given that airdropped units are received without any consideration, the entire fair market value of the coins on the date of receipt is taxable. Further, cryptocurrencies that were held as investments do not generate income (either ordinary or capital gain income) at the time of a hard fork and is not taxable. However, a hard fork in relation to cryptocurrencies held in the course of a business are treated as trading stock and must be accounted for as taxable income within the income year in which the new tokens are received.[131] The current tax treatment of ICOs follows from the attributes of the tokens that are issued. For example, some ICOs offer tokens with equity-like characteristics in the form of voting rights or profit participation, while other ICOs offer tokens that give rights to the future use of a platform. As a result, tax in the hands of the issuer depends on a number of factors, including whether ICOs are issued in the form of a managed investment scheme, an offer of shares or other forms of equity, an offer of a derivative etc.[132]

Like Australia, in **Canada**, new units of cryptocurrency acquired via mining activities of a commercial nature are considered as business income at the value of the mined asset when the asset is received, and is treated as inventory of the business. However, if the acquisition is a speculative investment instead, the first taxable event occurs at the time of disposal of the asset.[133] The Canadian Revenue Agency ("**CRA**") has not released any specific

[125] Note 21 *supra*.
[126] *ibid*.
[127] *ibid*.
[128] *ibid*.
[129] Note 59 *supra*.
[130] FCA, 'Guidance on Cryptoassets Feedback and Final Guidance to CP 19/3' (*Policy Statement PS19/22*, July 2019) available at <https://www.fca.org.uk/publication/policy/ps19-22.pdf > [Last accessed January, 2022].
[131] Note 59 *supra*.
[132] Issue paper on Initial Coin Offerings, The Treasury, The Government of Australia (January 2019) available at <https://www.iosco.org/library/ico-statements/Australia%20-%20Australian%20Treasury%20-%20Issues%20Paper%20-%20Initial%20Coin%20Offerings%20-%20January%2031,%202019.pdf> [Last accessed March, 2022]
[133] Canada Revenue Agency, Government of Canada, "*Guide for cryptocurrency users and tax professionals*", available at <https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/digital-currency/cryptocurrency-guide.html> [Last accessed January, 2022].

guidance in the case of staking and hence tax implications are generally assumed to be similar to those applicable on mining.[134] Similarly, the CRA has not released any specific guidance on how airdrops, ICOs, forks, or pre-sales are taxed. However, Canadian tax professionals have inferred based on what is considered business income as per the limited official guidance that these events are unlikely to be taxed at the time of receipt. However, the user will be liable to pay capital gains tax on a subsequent disposal of the tokens.

Unlike Australia and Canada, the **United Kingdom** does not draw a distinction in its treatment of the acquisition of new units of cryptocurrencies. The acquisition of new tokens from mining is treated as taxable on receipt, regardless of whether it is received in the course of trade or not. If the mining activity is not carried out in the course of trade, receipt of new cryptocurrencies results in miscellaneous taxable income for the miner. However, if the mining activity does amount to a trade, the value of the assets at the time of receipt is taxed as trading profits.[135] The tax treatment in case of staking is the same as that of mining. Interestingly, unlike Australia, airdrops are not taxable at the time of acquisition in the United Kingdom, if not received in exchange for consideration. Similarly, units received in the case of hard forks are not taxable at the time of initial acquisition and are subject to a pooling approach under the capital gains regime at the time of secondary sale. The basis cost of the new tokens is derived from the original crypto-assets already held. The new virtual currencies received after a hard fork are placed in their own pool, separate from the pool for the original token type.[136] Further, in case of ICOs, a taxpayer will be liable to pay capital gains tax on the sale proceeds earned through disposal of units in exchange for the ICO token. The "sale proceeds" here will be the market value of the existing units and not the new token.[137]

In the **United States**, taxpayers who mines cryptocurrencies has to include their fair market value in gross income as at the date of receipt regardless of whether such mining has been done during the course of business or not. If the mining constitutes a trade or business, the net earnings from the trade are considered as self-employment income when received. Whereas if the mining constitutes as a hobby, then the mined units are taxed under the head ordinary income.[138] The Internal Revenue Service ("**IRS**") has not yet provided any specific guidance on tax implications on staking. However, the IRS guidance on mining (i.e., IRS Notice 2014-21) supports that there could still be tax implications for staking activities because of its similarity to mining. Accordingly, a staking reward will likely be taxable at its fair market value on the date of acquisition. Further, if a taxpayer's staking activities do constitute a trade or business, any ordinary and necessary expenses related to staking operations are deductible. On the other hand, if the activities are viewed by the IRS as a hobby, any staking-related expenses are disallowed under tax reform legislation passed by Congress in 2017. Similarly, if taxpayers engage in staking for investment purposes, they are eligible to claim only limited investment-related expenses (within limits) and cannot deduct ordinary business expenses.[139] Unlike other jurisdictions, hard forks and airdrops are taxable in the United States when a user "actually and constructively" receives the cryptocurrency units owing to a hard fork or an airdrop and has "dominion and control" over those assets as evidenced by the taxpayers' ability to immediately sell, exchange or transfer the new units. Hence, the date of airdrop or hard fork without transfer of dominion and control of the units is not taxable by itself.[140]

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[134] Oleg Galeev, "*Crypto Taxation In Canada: All You Need To Know in 2022*", OcryptoCanada, (January 2022), available at <https://ocryptocanada.ca/guides/crypto-taxation-in-canada/> [Last accessed January, 2022].
[135] Policy Paper: Tax on cryptoassets, HMRC, Government of UK, available at <https://www.gov.uk/government/publications/tax-on-cryptoassets> [Last accessed March, 2022].
[136] *ibid*.
[137] A Guide To Tax on Cryptocurrency in the UK, Accounts and Legal (8 March 2021) available at <https://www.accountsandlegal.co.uk/tax-advice/tax-on-cryptocurrency-UK> [Last accessed March, 2022].
[138] Frequently asked questions on virtual currency transactions, IRS, United States Government, available at <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions> [Last accessed March, 2022].
[139] Jason B. Freeman, "*The taxation of Staking, Freeman Law*", available at <https://freemanlaw.com/the-taxation-of-staking/> [Last accessed March, 2022].
[140] Frequently asked questions on virtual currency transactions, IRS, United States Government, available at <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions> [Last accessed March, 2022].

Method for acquisition of new token	Australia	Canada	The UK	The US
Mining				
In the course of business	Taxable	Taxable	Taxable	Taxable
Not in the course of business	Not Taxable	Not Taxable	Taxable	Taxable
Staking				
In the course of business	Taxable	Taxable	Taxable	Taxable
Not in the course of business	Taxable	Not Taxable	Taxable	Taxable
Pre-token sales				
In the course of business	May be taxed	Not Taxable	Not Taxable	May be taxed
Not in the course of business	May be taxed	Not Taxable	Not Taxable	May be taxed
ICOs				
In the course of business	May be taxed	Not Taxable	Not Taxable	May be taxed
Not in the course of business	May be taxed	Not Taxable	Not Taxable	May be taxed
Airdrops				
In the course of business	Taxable	Not Taxable	Not Taxable	Taxable
Not in the course of business	Taxable	Not Taxable	Not Taxable	Taxable
Forking				
In the course of business	Taxable	Not Taxable	Not Taxable	Taxable
Not in the course of business	Not Taxable	Not Taxable	Not Taxable	Taxable

The disposal of cryptocurrencies is the next potential taxable event in the lifecycle of cryptocurrencies. This disposal on the secondary market may be i) for fiat currency; ii) for another cryptocurrency; iii) for the payment of goods or services; iv) without a reciprocal exchange of value, e.g., via gift, inheritance etc.; or v) loss or theft. As noted, disposal of cryptocurrencies is often treated as the first taxable event in several jurisdictions. Several countries however base their treatment of whether disposal will be taxed on the nature of the person engaging in the transaction. For instance, countries such as Grenada, Italy, the Netherlands, Portugal and Switzerland do not consider any exchanges made by individuals to be a taxable event for the individual in question.[141] Several countries however do consider exchanges between cryptocurrencies and fiat currency to be a taxable event. With a few exceptions, the same group of countries also consider exchanges between two forms of cryptocurrencies to constitute a taxable event. Countries that do not consider exchanges with other virtual currencies to be taxable include Chile, France, Latvia and Poland.[142] Several countries such as Argentina, Australia, Austria, Belgium, Canada, Estonia, Finland, France, Greece, Ireland, Israel, Japan, Luxembourg, Netherlands, Slovak Republic, Slovenia, South Africa, Spain, Sweden and the United Kingdom base the tax implications on such exchanges on whether the same are done in the course of business or not. For instance, persons or companies involved in occasional activities for personal purposes are subject to capital gains taxes, while exchanges considered to be conducted in the course of business, either because of the volume, frequency, profitability, or status of the trader, are typically treated as taxable income under business or ordinary income.[143] The tax treatment of disposal of cryptocurrencies for some countries is examined here in detail:

In **Australia** for example, the tax treatment on disposal varies depending on whether the exchange of cryptocurrency is made by a business that deals in cryptocurrencies. Individuals that are not engaged in the business of cryptocurrencies are taxed on their gains from the disposal of the units. These individuals may also qualify for a capital gains tax discount if the asset was held for longer than a year prior to disposal. Though, in some cases where the units are exchanged for goods and services, capital gains tax does not apply provided the cryptocurrency is being used to purchase goods or services for personal consumption and the value of the purchased goods is less than AUD 10,000. On the other hand, if a person carries on a business that involves transacting with cryptocurrencies, the trading stock rules apply rather than the capital gains tax. Under these rules, the total proceeds from the exchange of the cryptocurrency are treated as ordinary income and the cost

[141] Note 21 *supra.*
[142] *ibid.*
[143] *ibid.*

of acquiring the assets held as trading stock is deductible. Disposals other than for consideration such as gifts are taxable in the hands of the donor as capital gains tax, although exemptions exist for donations to registered charities.

In **Canada** too, the tax treatment on disposal varies depending on whether the exchange of cryptocurrency is made by a person engaged in the business that involves transacting with cryptocurrencies or not. In the case of the former, taxpayers are subject to tax on their business income and the cost of acquiring the assets held as trading stock is deductible. Whereas, in case of the latter, taxpayers are subject to a capital gains tax. Further, the supplier receiving the cryptocurrency in exchange of goods and services is also liable to include the value of the units on the date of the receipt in his business income. Gifting cryptocurrency in Canada is viewed as a disposal of asset and is subject to capital gains tax. Though, donating crypto to a registered charity is tax neutral.[144]

In the **United Kingdom**, the tax implications on disposal of cryptocurrency are the same as Canada. Therefore, if the exchange is conducted by a cryptocurrency business, the transaction is treated as business income, and in other cases, a disposal of cryptocurrency is treated as capital gains. Further, the supplier receiving the cryptocurrency in exchange of goods and services may also have to include the value of the units on the date of the receipt in his business income. The treatment of gifts in the United Kingdom is also the same as Canada, with the exception that gifting units to the spouse or civil partner of the donor or to registered charities is viewed as tax neutral. Further, cryptocurrency forms part of the property considered for computation of a person's estate and there may be inheritance tax implications.[145]

The **United States** also employs a model where the tax implications on disposal of cryptocurrencies is different for businesses engaged in cryptocurrencies and other taxpayers. While disposals made by the former are treated as business income, the latter is treated as capital gains. Further, a supplier receiving cryptocurrency units as consideration for supply of goods/services is required to add the value of such units in his taxable income. Even in the case of gifts, tax is levied on the donor, with the exception that a gift of less than USD 15000 does not trigger a tax liability for the donor or the recipient.[146]

[144] Crypto Tax Canada: Ultimate Guide 2022, Koinly Guide, available at <https://koinly.io/guides/crypto-tax-canada/> [Last accessed February, 2022].
[145] Hayden Bailey, "*Can I pay less inheritance tax on cryptocurrencies*?", Boodle Hatfield, available at <https://www.boodlehatfield.com/articles/inheritance-tax-on-cryptocurrencies/> [Last accessed February. 2022].
[146] Frequently asked questions on virtual currency transactions, IRS, United States Government, available at <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions> [Last accessed March, 2022].

Method for disposal of cryptocurrencies	Australia	Canada	The UK	The US
Exchanged for fiat currency				
In the course of business	Taxable	Taxable	Taxable	Taxable
Not in the course of business	Taxable	Taxable	Taxable	Taxable
Exchanged for other cryptocurrencies				
In the course of business	Taxable	Taxable	Taxable	Taxable
Not in the course of business	Taxable	Taxable	Taxable	Taxable
Exchanged for goods or services				
In the course of business	Taxable	Taxable	Taxable	Taxable
Not in the course of business	Taxable	Taxable	Taxable	Taxable
Disposed for no consideration such as a gift or as an inheritance				
In the course of business	Not Taxable	Not Taxable	May be taxed	May be taxed
Not in the course of business	Taxable	Taxable	Taxable	Taxable
Disposal owing to loss or theft				
In the course of business	Not Taxable	Not Taxable	Not Taxable	Not Taxable
Not in the course of business	Not Taxable	Not Taxable	Not Taxable	Not Taxable

1.3. *Valuation*

Given the degree of volatility associated with cryptocurrencies and the lack of standardization in factors determining its value, ascertaining the value of cryptocurrencies for tax purposes is imperative. The OECD surveyed several countries and determined that guidance on valuation for tax purposes appears to be limited and where such guidance does exist, it acknowledges the difficulties in assessing the value of virtual currencies.[147] Some of the countries that have issued guidance on valuation are listed below:

In **Canada**, as per the CRA, the valuation of cryptocurrencies depends on whether it is considered as capital property or inventory for tax purposes. When cryptocurrencies are held as capital property, they must be recorded and tracked on an adjusted cost base. The adjusted cost base is usually the cost of a property plus any expenses incurred to acquire it, such as commissions and legal fees. Where the cryptocurrencies are considered to be inventory, one of the following two methods of valuing inventory has to be used consistently every year:

(i) each item in the inventory is valued at its cost when it was acquired or its fair market value at the end of the year, whichever is lower. The term "cost" here refers to the original cost of the particular item of inventory (for example, a block of cryptocurrency), plus all reasonable costs incurred to acquire it.[148]; or

(ii) the entire inventory is valued at its fair market value at the end of the year (generally, the price that you would pay to replace an item or the amount that you would receive if you sold an item)

In the **United Kingdom**, as per guidance released by the HMRC, where a cryptocurrency is traded on exchanges which do not use pound sterling, the value of any gain or loss must be converted into pound sterling by the taxpayer in their self-assessment tax return. However, if the transaction does not have a pound sterling value (for example if one cryptocurrency is exchanged for another cryptocurrency) an appropriate exchange rate must be established in order to convert the transaction to pound sterling. The valuation methodology must be used consistent methodology and a record of its details should be kept.[149]

[147] Note 21 *supra*.
[148] Canada Revenue Agency, Government of Canada, Guide for cryptocurrency users and tax professionals, available at <https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/digital-currency/cryptocurrency-guide.html> [Last accessed January, 2022].
[149] Note 135 *supra*.

In the **United States**, the IRS allows taxpayers to record the valuation of cryptocurrency on the following basis[150]:

(i) On receipt of cryptocurrency through a cryptocurrency exchange, the value of the cryptocurrency is the amount that is recorded by the exchange in USD. If the transaction is facilitated by a centralized or decentralized cryptocurrency exchange but is not recorded on a distributed ledger or is otherwise an off-chain transaction, then the fair market value would be the amount the cryptocurrency was trading for on the exchange at the date and time the transaction would have been recorded on the ledger if it had been an on-chain transaction;

(ii) On receipt of cryptocurrency where a cryptocurrency exchange is not involved, the fair market value of the cryptocurrency is determined as on the date and time when the transaction is recorded on the distributed ledger, or would have been recorded on the ledger if it had been an on-chain transaction. The IRS will accept as evidence of fair market value the value as determined by a cryptocurrency or blockchain explorer that analyzes worldwide indices of a cryptocurrency and calculates the value of the cryptocurrency at an exact date and time. Where a user does not use an explorer value, the user must establish that the value used is an accurate representation of the cryptocurrency's fair market value; and

(iii) On receipt of cryptocurrency where the published value is not available, then the fair market value of the cryptocurrency received is equal to the fair market value of the property or services exchanged for the cryptocurrency when the transaction occurs.

2. Tax on supply of goods and services

The income tax treatment of cryptocurrencies, like most other goods and services, is generally distinct from their VAT treatment. Many of the transactions discussed in the previous section as having income tax implications may also attract tax on their consumption. Typically, Value Added Tax ("**VAT**") or GST is applied on the supply of goods or services. Given that cryptocurrencies are being increasingly used as consideration for supply of goods and services, studying the implication of these transactions under the GST regime is critical. This section examines the development of the VAT treatment of cryptocurrencies in certain key jurisdictions.

The GST treatment of cryptocurrencies has been regularly evaluated by the Australian tax authorities. The ATO released for the purpose of stakeholder consultation, a series of rulings in 2014 containing among other things, the GST treatment of cryptocurrencies. For the purposes of GST, Bitcoin was treated as "intangibles" under said ruling.[151] The exclusion available to transactions in money was held to be inapplicable to Bitcoins as they were held to not constitute money.[152] Accordingly, the domestic supply of Bitcoin in exchange for money was held to be taxable. Further, the domestic supply of taxable goods or services in exchange for Bitcoin was also held to be taxable, akin to barter arrangements.153 In 2017 however, the A New Tax System (Goods and Services Tax) Act 1999 (the "**Australian GST Act**") was amended "*to ensure that supplies of digital currency receive equivalent goods and services tax (GST) treatment to supplies of money, particularly foreign currency*".[154] Accordingly, the definition of "supply" and some other ancillary provisions of the Australian GST Act were amended to effectively state that purchase of taxable goods and services in exchange for digital currency will continue to attract GST liability. However, the purchase of digital currency in exchange for money or other digital currencies.[155]

The European Union has extensively evaluated the VAT implications of transactions in cryptocurrencies. In the case of ***Skatteverket v. David Hedqvist***[156] the ECJ assessed the applicability of VAT in cases of exchange of

[150] Frequently asked questions on virtual currency transactions, IRS, United States Government, available at <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions> [Last accessed March, 2022].
[151] Note 59 *supra*.
[152] Note 59 *supra*.
[153] Note 59 *supra*.
[154] Treasury Laws Amendment (2017 Measures No. 6) Bill 2017.
[155] Treasury Laws Amendment (2017 Measures No. 6) Bill 2017.
[156] Note 61 *supra*.

traditional currency for cryptocurrencies (in this case, Bitcoin) and vice versa. The ECJ held that the transactions at issue do not constitute supply of goods under Article 14 of the VAT Directive as it did not consider Bitcoin as tangible property.[157] The ECJ held that the transaction in question amounted to a supply of services. However, the service in question was found to be covered under the exemption extended to *"transactions including negotiation, concerning currency, bank notes and coins used as legal tender, with the exception of collectors' items, that is to say, gold, silver or other metal coins or bank notes which are not normally used as legal tender or coins of numismatic interest"*[158]. It was held that this exemption left scope for ambiguity around covering within its scope transactions relating to not just traditional currency, but also other currencies. Cryptocurrencies were held to be comparable to fiat currencies, in that their sole purpose was to provide a means of exchange. It was held that "*their function in a transaction is simply to facilitate trade in goods in an economy; as such, however, they are not consumed or used as goods (…) Bitcoins also constitute a pure means of payment. The only purpose of possessing them is to reuse them as a means of payment at some point. For the purposes of the chargeable event for VAT, therefore, they must be treated in the same way as legal tender"*[159]. Therefore, a transaction that involved changing fiat currency for cryptocurrency (and vice versa) was held to be exempt. The ECJ in passing its decision, also accounted for the purpose behind the exemption in question, which was to avoid several difficulties associated with determining a taxable amount of such transaction. Given that these difficulties would be equally applicable to cryptocurrencies, the exemption was held to extend to the transaction in question too.[160] After this decision, the EU Value Added Tax Committee[161] considered the tax implications of other transactions in the cryptocurrency ecosystem. As far as the use of Bitcoins for supply of good and services is concerned, it was held established that in such cases, Bitcoin merely acts as a means of payment. Therefore, no VAT should be charged on the value of the Bitcoin themselves, however, the taxable amount on which VAT is levied should be the equivalent value in a legal tender currency of that consideration.[162] Lastly, the VAT implications on the receipt of transaction fee and new Bitcoin tokens generated in the process of mining were assessed. It was decided that the receipt of transaction fee by miners, does not have a direct link with the activity performed by them.[163] It was noted that the transaction fee is voluntary, and from the perspective of the miner, his activity of verification "does not create any right to receive a transaction fee from the user whose transactions have been successfully included in the blockchain"[164]. Next, the VAT implications of miners' receipt of new Bitcoin tokens was examined. The committee concluded that the activity performed by miners "does not only lead to the creation of new units of the virtual currency, but it also plays a fundamental role in keeping the Bitcoin system operative and trustworthy by ensuring the accuracy of the transactions data"[165]. Given this correlation, the Committee concluded that the services supplied by miners can be argued to be linked to the supply of bitcoins themselves and, therefore, may be seen as an exempt transaction concerning currency within the meaning of Article 135(1)(e), or concerning payments and transfers under Article 13(1)(d) of the VAT Directive.[166] Most EU states use this mechanism, with slight variations.[167]

At present therefore there is some consensus across countries on the treatment of transactions in cryptocurrencies. Typically, transactions in cryptocurrencies are treated at par with transactions in money. Accordingly, most countries hold that the exchange of cryptocurrencies for fiat currency, or other virtual currencies is not leviable to GST. The supply of taxable goods or services using cryptocurrencies however is viewed as a taxable event. The route to reach this conclusion however is vastly different. As illustrated, for the purposes of EU law, the existing VAT regime was read widely enough to include cryptocurrencies within the scope of "money". In Australia however, this interpretation was found to be inconsistent with the Australian GST Act and an amendment was made to deem cryptocurrencies at par with foreign currency for the purposes of the GST law.

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[157] Note 89 *supra.*
[158] Art. 13(1)(e) Council of the European Union VAT Directive, 2006.
[159] Note 61 *supra.*
[160] Note 21 *supra.*
[161] Note 89 *supra.*
[162] *ibid.*
[163] *ibid.*
[164] *ibid.*
[165] *ibid.*
[166] *ibid.*
[167] Note 21 *supra.*

E. The way forward

1.Income tax framework

The Government has introduced a simplified regime of levying a high, but standard rate of tax on all types of transactions. In the short term, a simple tax mechanism will likely help in reducing ambiguity and providing certainty to taxpayers. However, in the longer run adopting a standard rate may disrupt the cryptocurrency industry as a high tax rate will be applicable on every transfer thereby substantially increasing the tax cost.

Additionally, from 01 July 2022 onwards, any person paying consideration to a resident of India in exchange for cryptocurrency shall be obligated to withhold tax at the rate of one per cent on the consideration so paid, subject to certain monetary thresholds. The applicability of such withholding tax on every transaction will have a significant adverse impact on the liquidity in the cryptocurrency ecosystem and discourage innovation in that space. Where the consideration payable is wholly or partly in-kind, the payer must ensure that tax is paid in respect of such transaction, before paying the consideration. Enforcing this will be difficult and may result in the payer being held in default. Hence, from a withholding tax compliance perspective, there may be certain practical challenges, especially for traders of cryptocurrency, such as keeping a record of the identity or tax residence of sellers etc. A withholding tax mechanism also does not serve any significant purpose for the tax authorities as it does not add to the treasury's revenue, instead it only increases administrative cost. Such an onerous requirement could be argued to theoretically assist the authorities with obtaining information about transfers of cryptocurrencies but given that such a mechanism is nearly impossible to enforce at a peer-to-peer level, even the potential access to information does not justify its introduction.

The cryptocurrency tax structure suggested in the 2022 Union Budget also violates a key principles of sound tax policy – neutrality. Neutrality suggests that generally, tax systems should strive to be neutral so that decisions are made on their economic merits and not for tax reasons.[168] Deviations from a neutral tax system reflect the goals of policymakers. In this case, it is apparent that the policymakers are looking to disincentivize transactions in cryptocurrencies, However, the disincentives should be designed such that they account for the social costs of certain actions. The overall objectives of the disincentives should be to help ensure that the outcome of decentralized decisions and market competition leads to overall social efficiency.[169] The introduction of such disincentives should also be preceded by an analysis into whether disincentives in the tax system are the best way to achieve the policy objectives in question. In the present scenario, the introduction of a high rate of tax appears to be ad-hoc and possibly even disproportionate to the social costs of transacting in cryptocurrencies. The move also appears to be a lazy attempt at resorting to the tax system as the first mechanism for disincentivizing an activity, when regulating it would be a far more effective, proportionate, and sustainable way forward.

Accordingly, going forward, it is recommended that India should include cryptocurrencies within the fold of capital assets or stock-in trade, as the case may be, as it stood prior to the amendment of 2022, like other jurisdictions and levy tax accordingly. Further, the withholding provision should be done away with. Given the intention behind introducing such provision is to ensure tax compliance, the withholding obligation may be swapped with some form of record keeping, return filing, or documentation mandate. This will serve the dual purpose of ensuring compliance while not affecting the industry as well as the treasury.

The tax regime may be implemented by way of issuing clarifications with respect to the following:

[168] Jason Furman, "*The Concept of Neutrality in Tax Policy*", Testimony Before the U.S. Senate Committee on Finance Hearing on Tax Fundamentals in Advance of Reform (15 April 2008) <https://www.brookings.edu/wp-content/uploads/2016/06/0415_tax-_neutrality_furman-1.pdf> [Last Accessed April 2022].
[169] *Ibid.*

➢ Nature of cryptocurrencies

The nature of cryptocurrency is important since it has a direct impact on its classification and tax treatment. In the preceding chapters, the working paper discusses multiple taxable events and use cases that are often found in the cryptocurrency ecosystem. Broadly, clarity with respect to factors that will help determine whether holding a cryptocurrency unit would amount to a capital asset or a stock-in trade in different situations will be of paramount importance.

➢ Identification of taxable events

There are multiple players participating in the entire lifecycle of cryptocurrencies, from creation to final disposal. This results in various potential taxable events. While it may not be possible at this stage to identify and subject all entities to a nuanced tax regime, it is crucial to work towards adopting a framework that takes into account the character of each transaction. Accordingly, the government would be required to clarify which transactions will fall within the tax ambit and mechanism of levying taxes. For instance, in the US, the official website of the IRS provides an exhaustive list of FAQs on virtual currency transactions[170] that enables taxpayers as well as tax authorities to be aware of the tax implications that will apply in case of different taxable events.

➢ Tax implications of specific use cases

Policymakers remain concerned about the use of cryptocurrencies due to its volatility and its impact on the environment. Further, cryptocurrency ecosystem is still evolving. Accordingly, the government should undertake a detailed risk and benefit analysis of different use cases and where the intention is the curb certain kinds of transactions, the government may consider levying a specific tax rate for such transactions as opposed to applying a high rate of tax on all transfers. For instance, long term investments in cryptocurrency may be subject to a lower rate of tax. This will serve the dual purpose of protecting investors and at the same time encouraging the industry.

➢ Valuation

A significant challenge in effectively taxing cryptocurrencies is ascertaining their value. For one, cryptocurrencies are notoriously volatile. Within a span of three months between November 2021 to January 2022, Bitcoin for instance lost over USD 27,000 which amounted to a dip of 40%.[171] Further, there is no consistency in the value of cryptocurrencies. Their prices vary between platforms and even between geographies. For instance, the price of Bitcoin fell sharply on Indian exchanges as a response to factors that impacted its local demand and supply.[172] Generally, the prices of cryptocurrencies on Indian exchanges trade at a premium compared to global prices due to various factors such as volumes, market efficiency, currency risk and transaction costs.[173] Even within the same geographical jurisdiction, prices vary across exchanges as there is no standard established way to value these cryptocurrencies. Even where the parameters for valuing the cryptocurrencies may be consistent, the values may vary. For instance, trading volumes will be much higher at larger exchanges, as compared the smaller ones.[174] Given that the purchase and sale value of any commodity or service is the core basis for calculating tax

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[170] Frequently asked questions on virtual currency transactions, IRS, United States Government, available at <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions> [Last accessed March, 2022].

[171] "*Bitcoin price falls to lowest since September down 40% from record high*", Livemint (January 7, 2022) available at <https://www.livemint.com/market/cryptocurrency/bitcoin-ether-prices-today-fall-to-lowest-since-september-down-40-from-record-high-11641542098606.html> [Last accessed February, 2022].

[172] *Explained: Why was bitcoin trading cheaper in India today compared to global prices?*, CNBCTV18.com (November 24, 2021) <https://www.cnbctv18.com/cryptocurrency/explained-why-was-bitcoin-trading-cheaper-in-india-today-compared-to-global-prices-11578612.htm> [Last accessed February, 2022].

[173] *ibid.*

[174] Bob Pisani & Todd Haselton, "*Here's why bitcoin prices are different on each exchange*", CNBCTV18.com (December 12, 2017) <https://www.cnbc.com/2017/12/12/why-bitcoin-prices-are-different-on-each-exchange.html> [Last accessed February, 2022]

liability, the challenges related to cryptocurrencies' valuation is a significant impediment to designing an effective tax structure.

Accordingly, going forward, certainty with respect to valuation of cryptocurrencies will be required. Reliance in this regard may be placed on international experience (*as set out in the preceding sections of the working paper*). For instance, jurisdictions such as US compute the fair market value of a cryptocurrency not listed on a stock exchange based on the date and time when the transaction is recorded on the distributed ledger. Similarly, in the UK, where a cryptocurrency is traded on exchanges which do not use pound sterling, the value of any gain or loss must be converted into pound sterling by the taxpayer in their self-assessment tax return. However, if the transaction does not have a pound sterling value (for example if one cryptocurrency is exchanged for another cryptocurrency) an appropriate exchange rate must be established in order to convert the transaction to pound sterling.

➢ Determining the situs of cryptocurrency

Any taxation framework typically places substantial emphasis on the situs of the taxable event while ascertaining the tax liability. Several relevant factors may be considered to determine the situs of a transaction, for instance the location of the parties involved in a transaction, the location of the asset in question etc. Given the nature of cryptocurrencies, ascertaining the physical location of these factors is particularly complicated.

Cryptocurrencies can be stored in different types of wallets and determining their location is nearly impossible. Generally, a "wallet provider is an entity that provides a virtual currency wallet (i.e., a means (software application or other mechanism/medium) for holding, storing and transferring bitcoins or other virtual currency). A wallet can hold the user's private keys, which allow the user to spend virtual currency allocated to the virtual currency address in the block chain. A wallet provider facilitates participation in a virtual currency system by allowing users, exchangers, and merchants to conduct virtual currency transactions easily. The wallet provider maintains the customer's virtual currency balance and generally also provides storage and transaction security". There may be custodial wallets that hold users' private keys on their behalf. Such custodial wallets may either store the cryptocurrency online, called hot storage, or offline, called cold storage. There may also be several ways in which users may store cryptocurrencies while retaining possession of their private key. For instance, hot non-custodial wallets offer a solution where the user downloads a software application to create a wallet on their own computer and store their private key. Cold hardware wallet on the other hand offers a solution where a physical device (similar to a USB/flash drive) is kept offline, but it can be connected to an online computer when needed. Further, a cold paper wallet refers to a situation where the "users record their private key on pieces of paper. These keys and addresses can be generated by downloading a piece of software, which is then run on an offline computer and printed, before deleting the wallet before the computer is re-connected to the internet".

Hence, clear guidelines with respect to situs of cryptocurrency are required to ensure that the ecosystem is taxed in an efficient manner. In respect of the Indian income tax framework, the situs of the cryptocurrencies may be linked to the tax residency of the cryptocurrency user as opposed to where or how it is stored.

➢ Reporting and compliance

The degree of anonymity associated with transactions in cryptocurrencies is often identified as a fundamental roadblock in effectively regulating the sector. This feature also sets cryptocurrencies apart from other more traditional financial instruments and could adversely impact the efficacy of any tax enforcement measures. This issue however has been recently established as being relatively less challenging as far as Bitcoins and many existing cryptocurrencies are concerned.[175] "Contrary to popular belief, most existing cryptocurrencies do not provide full anonymity. Bitcoin is *pseudonymous*. Therefore, transactions in Bitcoin are typically linked to the wallet address as opposed to name of the holder".[176] The transactional records of Bitcoin are stored on a public

[175] Note 16 *supra*.
[176] Note 16 *supra*.

blockchain. While a holder's name may not be directly connected to a Bitcoin transaction, the public network enables people to see everyone's public address and accordingly it "doesn't take much to pair an identity to a public key."[177] Therefore, regulators are often able to "track cryptoasset transactions by using metadata stored on the relevant blockchain and applying pattern analysis."[178]

Going forward, the taxpayers involved in the cryptocurrency ecosystem may be subject to provisions relating to monitoring and reporting framework by way of introducing new tax returns. Such returns should allow taxpayers to classify their units as capital asset or stock-in trade based on the nature of the holding.

Alternatively, where the Government adopts the new income-tax regime of treating cryptocurrencies as a separate class of assets, it must clarify the tax implications at the time of mining and staking. As explained in the preceding sections of the working paper, taxability of creation of cryptocurrencies is currently ambiguous due to lack of clarity on whether the term 'transfer' would include the activity of mining and staking of cryptocurrency. Further, given that the new income-tax framework provides for a withholding obligation, the taxpayers may face certain practical challenges, especially traders of cryptocurrencies, such as keeping a record of the identity or tax residence of sellers etc. Accordingly, a detailed assessment of the withholding obligation should be done to address these concerns.

Separately, the interest in the cryptocurrency industry continues to increase as is evident with the increasing investment in the sector. Therefore, it is pertinent that the tax framework is coupled with measures that seek to create awareness amongst taxpayers and tax authorities. In doing so, the government should organise training sessions and awareness programs. This would not help the taxpayers in becoming cognizant of the potential tax implications but will also ensure that tax officers are equipped to monitor and track virtual transactions.

2. GST framework

As discussed in previous sections of this paper, based on the current GST framework, cryptocurrencies in general may not squarely fall under the scope of "money". The situation may be different for cryptocurrencies like Bitcoin that may be argued to qualify within the scope of "foreign currency". This ambiguity around the classification of cryptocurrencies under the GST framework should be eliminated. Based on the existing law it appears that cryptocurrencies are more likely to qualify as "goods", than money, however the CBIC's stand on the matter should be made clear and public.

If cryptocurrencies are clarified to be treated as "goods" under the GST framework, several complications are likely to ensue. These include:

- **Multiple taxable events**

Treating cryptocurrencies as "goods" will create several new taxable events. It will require one to first pay tax on their procurement using fiat currency, then their disposal in exchange for goods or services will be taxable as a barter transaction. Further, when the supplier of said goods and services seeks to convert them to fiat currency, tax will be payable again. The same transaction when conducted in fiat currency however will attract tax only once when a supply is made for the procurement of goods or services. While it is acknowledged that Indian policymakers consciously wish to treat cryptocurrencies different from fiat currency, using the GST law as a tool to do so will prove to be counterproductive. These many taxable events will only strain the tax authorities' administrative capabilities. Given that the GST regime is structured so as to allow credit on taxes paid on the input side, these multiple taxable events are also unlikely to make a substantial contribution to the exchequer.

[177] Hailey Lenon, 'Uncertainty to Profit on Right to Privacy' (*Forbes*, 10 November 2021) <https://www.forbes.com/sites/haileylennon/2021/11/10/crypto-investors-defy-regulatory-uncertainty-to-profit-on-right-to-privacy/?sh=b6b99e665a31> [Last accessed January, 2022].
[178] Note 62 *supra*.

Innovation in the cryptocurrency ecosystem is also likely to be stifled owing to the complexities associated with the GST framework.

- **Difficulty in ascertaining taxable value**

One of the key features of cryptocurrencies is that their value is extremely volatile, and it is not standardised. If cryptocurrencies are treated as "goods", a much larger number of transactions will be under the GST net, as compared to when they are treated as "money". While the issue of valuing transactions relating to cryptocurrencies will remain in either case, it will be exponentially exacerbated if they are treated as "goods". Specifically, valuing barter supplies is a complex task and is likely to lead to several long-drawn litigation.

- **Difficulty in maintaining records and computing input-tax credit**

The value of cryptocurrencies often varies drastically from point of purchase to point of sale. Therefore, the applicability of the input-tax mechanism as stipulated under the existing GST framework to transactions in cryptocurrencies is likely to run contrary to the fundamental principles of a GST regime. The GST that procurers of cryptocurrencies may pay and book as input tax credit at the time of purchase, may often be less than what they charge on sale of said cryptocurrencies due to a dramatic fall in their price. Given that the GST is contemplated as a tax on value-add, it does not typically account for such occurrences. Cryptocurrencies however are unique in this regard and hence should not be fit under the existing framework as "goods". Doing so will also further increase the already onerous compliances under the GST framework.

- **Difficulty in ascertaining place of supply**

GST implications of a transaction can vary significantly depending on the location of the parties involved in a transaction. The rules that determine this location under the existing framework rely heavily on the physical location of the parties. Given the decentralized and pseudo-anonymous nature of cryptocurrency transactions, ascertaining this location, and in cases such as block rewards, ICOs and pre-mine drops, ascertaining the two parties involved may also be an extremely difficult task.

- **Preference to foreign intermediaries**

It is acknowledged that the challenges of determining place of supply can be addressed by amending the GST laws and prescribing a place of supply for each transaction in the cryptocurrency ecosystem. However, it is likely that such rules will place Indian firms operating in the cryptocurrency ecosystem at a disadvantage as compared to foreign firms as supplies of goods or services to the latter will constitute exports and thus be zero-rated.

- **Departure from global practice**

The GST treatment of cryptocurrencies is more consistent across countries than income taxes. In almost all countries, their exchange is not subject to GST irrespective of whether the exchange is made for fiat currency or other cryptocurrencies. However, the supply of taxable goods and services paid with cryptocurrencies remain subject to VAT as appropriate.[179]

With the proliferation of cryptocurrencies, the concept of money is evolving at a rapid speed. While this evolution poses several pertinent threats, it also offers several valuable opportunities. Vidhi report titled 'Blueprint of a Law for regulating Crypto-assets'[180] makes a case for regulating cryptocurrencies so as to address the threat it may pose to the economic and financial stability of the nation. Upon separately analysing the issue from a taxation standpoint, this working paper concludes that there is a case to be made in support of treating

[179] Note 21 *supra.*
[180] Note 16 *supra.*

cryptocurrencies at par with money for the limited purposes of the GST law. This will foster neutrality, simplicity, transparency, and certainty to the framework. It concludes that utilizing the GST framework as a tool to deter players in the cryptocurrency ecosystem would prove to be unproductive. It will stifle competition, harm investor sentiment, conflict with the ethos of the GST framework which hinges on value addition, and also substantially increase litigation and administrative costs, without having a positive impact on revenue collection.

As a way forward, a detailed assessment should be conducted on whether cryptocurrencies qualify as “goods” or “money” under the GST framework. If this assessment suggests that they constitute goods, then an amendment should be made to the GST law specifically including cryptocurrencies to the definition of goods. A similar activity was undertaken in Australia and is being contemplated in Canada. The applicability of GST on mining and staking transactions also needs to be specifically assessed regardless of whether cryptocurrencies are taken to constitute “goods” or “money”.

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