Bitcoin – Concept and taxation aspects: Part I

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I. Bitcoin: What, when, why and how

Bitcoin is not simply a digital currency. Its underlying network-centric architecture is a cryptographic, shared and open, borderless ledger. Bitcoin does not need financial intermediaries such as PayPal and Visa, it is protocol-based form of programmable peer-to-peer money, with every participant using the same protocol. In this article, we use 'Bitcoin' interchangeably with the term, 'crypto-currency', of which class Bitcoin is the most prominent member.

Bitcoin obviates the need have an independent assurance provider to ensure there is no cheating, by distributing the ledger among all users. Every transaction in the Bitcoin economy is registered in a publicly distributed ledger, known as the Blockchain, and new transactions are checked against the Blockchain to eliminating possibility of the digital equivalent of 'counterfeiting'. Every participant **validates transactions** and **authenticates their source** by checking whether the bitcoin complies with well defined and established consensus rules and public key cryptography respectively. All transactions are time-stamped and stored in blocks in realtime on the Blockchain, and replicated on thousands of computers around the world.

Currency Issuance limits: Though theoretically, Governments can issue currency without limits, in practice, increase in money circulation is permitted by Governments, but within limits that are related to economic value created in the economy. If money supply within an economy rises beyond this figure, prices of goods and services tend to rise (which is called inflation), reducing the value of each unit of the currency. For the same reasons, any digital currency (Bitcoin is a genus of this species) also needs to have inbuilt control over the currency supply. This function is performed by the mechanism of **mining**. Mining in the digital sphere is a task that is commonly acknowledged as difficult and costly (in terms of time, computing power and resources), which alone can result in creation of brand-new units of a crypto-currency. Usually, a function of diminishing returns kicks in, and sets an absolute limit to the activity of, and incentives for, mining. The best analogy in the real world is the cost and difficulty of mining gold in the gold standard era (pre-Aug 1971). Blockchain blocks for each unit of new currency have to comply with **distributed consensus** rules that need validation by all network participants. This becomes progressively costlier, more difficult, or less rewarding, and it is expected that the supply of Bitcoins will be capped at 21 million units.

The central bank of every country backs each currency note with a promise to provide value. This is called 'fiat' and hence currencies issued by Governments are called 'fiat money'. Bitcoins and other crypto-currencies, in contrast, are secured by a decentralized trust mechanism in the form of an open, distributed ledger, called Blockchain. Each transaction in each unit of currency is 'time stamped' and this cannot be changed. Transaction costs are expected to fall sharply in the Bitcoin economy, in the absence of for-profit agencies charging fees for providing its services. This is likely to make small transactions and micropayments economical and viable. Also, a crypto-currency is by design almost inflation-neutral (except for permitted mining), whereas Governments all over the world tend to overspend, and tend to be inherently inflationary.

Concerns around crypto-currencies: Governments around the world (India is no exception) have been, and continue to be, wary of Bitcoins and other Blockchain based crypto-currencies, because of the anonymity surrounding the transactions and players. However, Blockchain is purpose-agnostic. It doesn't differentiate between good and bad participants. However, sophisticated Blockchain analysis tools have emerged that can allow law enforcers to trace transactions and unmask parties to the transaction. Also, by design, when a user tries to convert bitcoin into cash, the anonymity disappears.

One big concern of governments arises from the ability of crypto-currency users to flout capital control laws. Yet another concern is the extremely high volatility of value of Bitcoins. Risk is very high since no legal framework is in place to control its volatility.

Another disadvantage of crypto-currency systems is that if you forget the private key, the currency is lost forever. Another practical disadvantage is that peer-to-peer validation by network members will slow down the validation process and increase inconvenience to users. Sometime it may take hours to validate transaction.

II- Regulation and Taxation of Crypto-currencies

As bitcoins and other crypto-currencies are meant to be a medium of exchange, the question is whether they may be treated as currency for tax purposes, or whether they are assets having value as investment.

Bitcoin – Is it 'currency'? 'Currency' has not been defined in the tax laws. Guidance may be taken from the Foreign Exchange Management Act, 1999 (FEMA), which defines currency, as including all currency notes, postal notes, postal orders, money orders, cheques, drafts, travellers cheques, letters of credit, bills of exchange and promissory notes, credit cards or such other similar instruments, as may be notified by the Reserve Bank of India (RBI). So far RBI has not recognised Bitcoin or any other crypto-currency as a currency. Hence, it is not currency. They cannot be treated 'foreign currency' either. Under FEMA, foreign currency means any currency other than Indian currency, and Indian currency has been defined to mean currency that is expressed or drawn in Indian rupees but does not include special bank notes and special one rupee notes issued under section 28A of the Reserve Bank of India Act, 1934. Thus, Bitcoin or any other crypto-currency is neither an Indian currency nor foreign currency.

Bitcoin is money-equivalent, but not money and the Supreme Court of India in the matter of Kasturi & Sons[1] has held that the word money cannot be interpreted as "money's worth".

Bitcoin as asset or property/ store of value: Capital asset has been defined in section 2(14) of the Income-tax Act, 1961 (Income-tax Act) to include property of any kind held by the assessee. 'Property' is understood in a wide manner for tax purposes. The Kerala High Court, in the case of Syndicate Bank,[2] while analysing the definition of capital asset, has thrown light on the concept of property as follows: *The terms 'capital asset' has an all-embracing connotation and includes every kind of property as generally understood except those that are expressly excluded from the definition. So too, the meaning of the expression, 'property'. It includes every conceivable thing, right or interest or liability.* In addition, for property, the emphasis is on holding and enjoying, and not on ownership – this is explained by Madras High Court in the case of Madathil Brothers,[3] that the definition of “capital asset” under the Income-tax Act, referring to “property of any kind” carries no words of limitation. The definition includes every possible interest that a person may hold and enjoy. The definition of “capital asset” refers to property of any kind “held” by an assessee, in contradistinction to the word “owner,” or “owned”. Based on the above, Bitcoin is ‘property’, as the holder has exclusive right to spend/ access the Bitcoin he holds. Once Bitcoin is considered property, the general tax principles applicable to property transactions apply to transactions using Bitcoin. Below is a discussion of how existing general tax principles could apply to Bitcoin transactions.

Bitcoin/ crypto-currency transactions in business

*A Public Interest Petition (PIL) (Writ Petition (Civil) no. 406 of 2017), was filed under Article 32 of the Constitution of India in the Supreme Court, against Union of India, Ministry of Home Affairs, Ministry of Finance and Reserve Bank of India, against the use and business of illegal cryptocurrencies or Decentralised Digital Currency or “Virtual Currency” (VCs), such as, Bitcoins, litecoins, bbqcoins, dogecoins etc. During the course of hearing on 14th July 2017, the Bench of Hon'ble Chief Justice of India J.S. Khehar and Hon’ble Mr. Justice D. Y. Chandrachud, while disposing off the PIL, gave four weeks to the Reserve Bank of India to examine all security related issues about virtual currency, including Bitcoin, and respond to the Petitioners**[4]**. The report is still awaited.*

The discussion that follows assumes that there is no blanket ban on use of crypto-currencies, or other restrictions imposed on use of crypto-currencies by Indian taxpayers. Tax law does not currently bar acceptance of consideration in kind (which is what payments in crypto-currency will in all likelihood be treated as).

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[1] CIT v. Kasturi & Sons Ltd. (1999) 3 SCC 346

[2] Syndicate Bank Ltd. v. Addl. CIT [1985] 155 ITR 681 (Ker.)

[3] Madathil Brothers v. Dy. CIT [2008] 301 ITR 345 (Mad.)

[4] http://www.moneylaundering.legal/news-details.php?url=pil-writ-petition-civil-no-406-of-2017--was-filed-under-article-32-of-the-constitution-of-india-in-the-supreme-cou