Prospects of taxation of cryptocurrencies under GST

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Introduction

1. In recent times, crypto-currencies are most popular. Amongst them bitcoins are a rage. Hereinafter all the crypto-currencies will be referred as "bitcoins" for the sake of simplicity to have gained enormous popularity in the media because the value of same has sky rocketed. Many see it as an easy-money-making scheme without understanding its underlying fundamentals. The Government of India sees it as a Ponzi scheme. Warren Buffett has commented that bitcoins is not a currency and adds that he will not be surprised if 10 years down the line such crypto-currencies are no longer in existence. Jack Ma says that he does not understand bitcoins and adds that it is not a shame to accept that you don't know it. It is a shame only if you pretend that you know when, in fact, you don't.

In fact, in the United States various agencies are at odds in characterization of bitcoins. Courts in the context of law (18 U.S.C. § 1960) providing for prohibition against operating an unlicensed money transmitting business has held that the word "funds" used in the law means pecuniary resources, which are generally accepted as a medium of exchange or as a means of payment. Since bitcoins qualify the said test, the same will be regarded as "funds" and anyone operating bitcoin transmitting business can be prosecuted (see *United States* v. *Murgio*, 2016 WL 5107128). On the other hand, IRS in Notice 2014-21 has treated virtual currency as "property". As per IRS, virtual currency will not be treated as a currency that could generate foreign currency gain or loss for the U.S. federal tax purposes. Gain or loss shall be taxed either by classifying the virtual currencies as "capital assets" or as "stock-in-trade", based on the intent of the taxpayer in doing such transactions. It is ironical that Commodity Futures Trading Commission in its administrative decisions (Coinflip, Inc., CFTC No. 15-29, 2015 WL 5535736 (Sept. 17, 2015); Tera Exchange LLC, CFTC No. 15-33, at 4-5, n. 3 (Sep. 25, 2015); BFXNA Inc. d/b/a BITFINEX, CFTC No. 16-19, 2016 WL 3137612) has held that bitcoins are a commodity.

What is the real nature of bitcoins and how shall the same be taxed is the subject matter of this article.

Limitations of the barter system

2. Before we explain the concept, it may be noted that there is a difference between the terms 'Bitcoin' and 'bitcoin'. Bitcoin, where the "b" is in capital refers to the entire system itself. On the other hand, bitcoins, where the "b" is not in capital refers to the actual currency itself. You could say "I bought 10 bitcoins."

Think of any currency as some fiction created by humans to avoid the disadvantages of barter system. Under barter system one person supplies something (*e.g.,* goods or services) in return of another person also supplying something. However, this system has some disadvantages. First disadvantage is that a barter system requires double coincidence of wants. If you need something in return of what other person needs, only then can barter system work. If other person does not want what you can supply, barter system fails. Second disadvantage is that of absence of common value of measure. In a barter system, each transaction is unique in itself. Hence, there is no common measure in which the goods or services you supply can be measured. Third disadvantage is lack of divisibility. In a barter system, every transaction is expressed in what one receives against what one supplies. Hence, one cannot exchange less than the agreed exchange ratio. Fourth disadvantage is that in barter system you cannot store wealth. As something is always received in return, you will have difficulty in storing what one gets. It is also very expensive to store what one gets for future exchange. Fifth disadvantage is difficulty in deferred payments. Under barter system it is difficult to defer the other end of exchange as the parties may not agree to the future quality of goods to be given as well as the risk that the value of goods to be supplied in future may change with time. Last disadvantage is that under barter system, one cannot easily transport wealth from one place to another.

Birth of money

3. Above stated limitations of barter system led to the birth of money. From initial period when certain commodity (*e.g.,* precious metals) assumed the character of money. It evolved to paper currencies & coins and then to bank money. Currencies were pegged to gold reserves, *i.e.*, Central Bank issued currencies equivalent to gold reserves. Hence, till such time, all the monies issued had an inherent value (because precious metals have an inherent value). De-pegging of money with gold reserves happened in 1971. From then, on words money was issued without having equivalent gold reserves to support it. Hence, issuance of money became a policy decision by the Government & the Central Banks as they had free hand to print and create (in case of bank credit) more money in the system. This process creates inflation in the economy as when more money is printed, it chases finite number of goods or services required by people and, hence, more money drives up the prices. Issuance of money is backed up by only a promise by the Central Bank & the Government. Such currencies are regarded as fiat currencies. One theory supports a view that issuance of money is backed up by the power of the Central Government to levy and collect taxes.

Money, however, has resolved a number of limitations of the barter system. It is an easy store of value. Given the fact that money is created by the Government & Central Bank with a predefined inflation target, the worth of money is relatively stable. Money does not require double coincidence of wants. You can receive the goods that you need against money. Other person can use the money to get what he wants either from you or from some other person or even at a future date.

Money is easily divisible and is a single measure to express all the goods or services in the economy.

Money also has some limitations. First is that of trust deficit. Since humans don't trust one another naturally, issuance of money is done by institutions like Central Bank (*i.e.*, RBI), Government, Credit Card Companies, etc. For example, when you swipe a card at a shop, Credit Card Company assures to the shopkeeper that he shall receive the payment and at the same time also ensures that the amount spent is within your credit limits. This creates money in the system (based on the capital adequacy of Credit Card Company). Without such intermediary, shopkeeper will not trust you if you say that you will come back after a month and settle the payment. Similarly the Central Bank which issues the currency provides the same confidence to the people that the currency which they receive against supply of goods or services will be honoured in future. This trust comes at a cost as intermediaries like Central Bank charge hefty fees for running the monetary system (INR 65,876 crores was paid as dividend by the RBI in F.Y. 2015-16). Also, such intermediaries' (Central Bank along with Government) decide how and where you can move your money. Your money can also be frozen by the Authorities. Such intermediaries' can also reverse a transaction. It is also impossible to remit money maintaining anonymity. These factors led to the birth of bitcoins.

Birth of bitcoins

4. Bitcoin is a form of currency (although it differs greatly from presently accepted currencies) which is accepted by people who deal with it. Bitcoins are generated by an algorithm. The process is called as 'mining'.

Before we understand bitcoins, it is important to understand the concept of block-chain. In the past one was in a position to modify any entries in the ledger without disturbing successive entries, because every successive entry in the ledger was based on a predefined serial number and not on the preceding entry. You can think of block-chain as an online ledger which is visible to all. Every entry in the said ledger is linked with another entry through a complex set of mathematical algorithms so that any modification in the ledger will be immediately detected and will render the ledger untrustworthy. Think of this transaction log as an audit trail.

Bitcoin is based on block-chain technology. Online bitcoin ledger contains record of all the transactions that take place. It is a distributed ledger which resides in the computer network of all bitcoin users. There are persons (known as miners) who verify the entries of all the transactions made in the said ledger to ensure authenticity. During the verification process they make sure that every successive entry in the ledger is derived from preceding entry as per the algorithm developed by Satoshi Nakamoto (it is a pseudonym and no one knows who the creator was). For doing said work, miners are rewarded with bitcoins which is again generated by the algorithm. This creates new bitcoins. Said bitcoins can then be traded (*i.e.*, sold) against legal currencies through an exchange or can be used in certain jurisdictions to avail of goods or services. Hence, one can observe that there is as such no issuer of bitcoins. It is algorithm which creates it. However, the process of generation of bitcoins is finite and, hence, only predictable number of bitcoins can be mined. As the competition increases for mining, the number of bitcoins rewarded to miners decreases. There is also an upper cap in which case total bitcoins in circulation will not exceed 21 million. Before we discuss on tax implications, it is important to correctly categorize bitcoins. Are bitcoins money? Are bitcoins securities? Are they actionable claims? Are they movable property? Are they services? This is because as per section 7 of the CGST Act, 2017 tax is levied on making taxable supply of goods or services. Also, under Income Tax, depending on the categorization, income will be taxed under an appropriate head.

Section 2(*52*) of the CGST Act, 2017 defines goods to mean every kind of movable property other than money and securities, but includes actionable claims, 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.

Section 2(*102*) of the CGST Act, 2017 defines services 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.

From the above definitions one can observe that "securities" & "money" have been excluded from the definition of goods as well as services. Further, "actionable claims" other than lotteries, betting and gambling are covered by Schedule III to the CGST Act, 2017 and, hence, are not regarded as supply of goods or supply of services. Only activities relating to use of money or its conversion from one form of currency or denomination to another has been made taxable. Now let us analyze all possible scenarios.

Are bitcoins "securities" ?

5. The term "securities" is defined u/s. 2(101) of the CGST Act, 2017 as under:

> "Section 2(*101*) Securities shall have the same meaning as assigned to it in clause (*h*) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956)"

If one refers to Section 2(*h*) of the Securities Contracts (Regulation) Act, 1956 (42 of 1956), securities are defined as under:

> "Section 2(*h*) Securities include—
>
> (*i*) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;
>
> (*ia*) derivative;
>
> (*ib*) units or any other instrument issued by any collective investment scheme to the investors in such schemes;
>
> (*ic*) security receipt as defined in clause (*zg*) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
>
> (*id*) units or any other such instrument issued to the investors under any mutual fund scheme
>
> (*ii*) Government securities;
>
> (*iia*) such other instruments as may be declared by the Central Government to be securities; and
>
> (*iii*) rights or interest in securities."

The Apex Court in the case of *Sudhir Shantilal Mehta* v. *CBI* [2009] 96 SCL 403 has held that since the definition of "securities" is an inclusive definition, it takes within its purview not only matters specified therein but also all other types of securities as commonly understood. It should be given an expansive meaning. Clearly bitcoins are not expressly covered in the list stated above. Can it be covered as "securities" under an expansive meaning?

As per Webster Dictionary, the word "security" means something given, deposited, or pledged to make certain the fulfilment of an obligation. David L. Ratner in his book "Securities regulation in a nutshell" has stated that they have no intrinsic value in themselves. It derives value from the right that it represents over the person who issues the securities. It is an instrument which renders payment of a debt or performance of a contract. Hence, there will be two parties in such transaction. One is the issuer of security and another is the subscriber. Bitcoins cannot fall under this category as there is no issuer who contractually undertakes to repay the value represented by bitcoins or assures specific performance of a contract. Hence, it cannot be regarded as "securities".

Are bitcoins "actionable claims" ?

6. An actionable claim is defined u/s. 2(1) of the CGST Act, 2017 as under:

> "Section 2(1) "actionable claim" shall have the same meaning as assigned to it in section 3 of the Transfer of Property Act, 1882 (4 of 1882)"

If one refers to Section 3 of the Transfer of Property Act, 1882, actionable claim is defined as under:

> "actionable claim means a claim to any debt, other than a debt secured by mortgage of immovable property or by hypothecation or pledge of movable property, or to any beneficial interest in movable property not in the possession, either actual or constructive, of the claimant, which the civil courts recognise as affording grounds for relief, whether such debt or beneficial interest be existent, accruing, conditional or contingent"

The Apex Court in the case of *H. Anraj* v. *Govt. of T.N.* AIR 1986 SC 63 has held that 'actionable claim' defined in Section 3 of the Transfer of Property Act, 1882 comprises of two types of claims: (*a*) a claim to unsecured debt, and (*b*) a claim to beneficial interest in a movable property which is not in possession of a claimant. It must also be a right capable for enforcement.

Bitcoins are clearly not a claim to unsecured debt. This is because there is no person who is an issuer who guarantees repayment of a fixed value assigned to a bitcoin. Can bitcoin be classified as beneficial interest in a movable property not in a possession of claimant and of capable enforcement by the Courts? Bitcoins create no interest in a movable property which is not in a possession of claimant. As bitcoins are credited in the bitcoin wallet created by the buyer, it cannot be said that it represents an interest in a movable property in possession of someone else. Even presuming that bitcoins are "movable property", it cannot be said that owner of bitcoins has an interest in the said property which is in possession of someone else. In fact, it is in the online wallet of the buyer only. This brings us to next issue as to whether bitcoins can be called as "movable property"?

Are bitcoins "movable properties" ?

7. Goods is defined u/s. 2(52) of the CGST Act, 2017 to mean every kind of movable property other than money and securities but includes actionable claims, 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. Presuming without admitting that bitcoins are not money, can they be considered as "movable properties" and, hence, as "goods" ?

The Apex Court in the case of *Vikas Sales Corpn.* v. *Commercial Taxes* [1996] 4 SCC 433 has held, relying on "Salmond on Jurisprudence" that the expression 'movable property' includes corporeal as well as incorporeal properties. Debt contracts and other chooses-in-action are said to be chattels, no less than furniture or stock-in-trade. Similarly, patents, copyrights and other rights in rem which are not rights over land are also included within the meaning of 'movable property'.

There are two kinds of rights in the world which result in property (both corporeal as well as incorporeal) *viz.*, rights in rem (*i.e.*, rights against a thing - *e.g.*, ownership of tangible goods) & rights *in personam* (*i.e.*, rights against a person - *e.g.*, debts to be recovered from a debtor). Bitcoins are not tangible in nature and, hence, they cannot create rights in rem. As stated above, bitcoins are created by an algorithm. There is no issuer of bitcoins. Hence, it will be very difficult to say that an owner of bitcoins has a right against a person to receive the equivalent worth of bitcoins held by him. This is opposed to a legal currency which creates rights for an owner to ensure the receipt of equivalent value from the issuer (*i.e.*, the Central Bank or the Government). It is because of this right that the currencies issued by the Central Bank or the Government appear as liabilities in their books and as assets in the books of person who holds it (physically or in an account). In case of bitcoins as there is no person who can be termed as an issuer, as against the owner of bitcoins, no corresponding liability is created. Hence, it will be difficult to say that bitcoins are property. Hence, bitcoins cannot be regarded as goods.

The Tokyo District Court (based on Japan Times accessed on 29-12-2017) has dismissed a lawsuit by a man seeking repayment for bitcoins he kept in an account at the bankrupt exchange Mt. Gox Co., with the ruling saying that the virtual currency is "not subject to ownership" claims. It was held that virtual currency is not a property and hence any claim for theft of such currency cannot be entertained by the Courts.

Are Bitcoins "Money" ?

8. Money is defined u/s. 2(*75*) to mean 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 Reserve Bank of India 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.

As per P. Ramanatha Aiyar's Law Lexicon, a legal tender means a tender made in legal notes or coin. As per Section 22 of the RBI Act, 1934, the RBI has the sole right to issue bank notes (except Coins and 1 rupee notes which are minted/issued by the Central Government under the Coinage Act, 2011) in India. Further, as per Section 26 of the RBI Act, 1934 every bank note shall be a legal tender. As per Section 2 of Legal Tender (Inscribed Notes) Act, 1964 a note bearing messages of a political character shall not to be regarded as a legal tender. Hence, going by strict definition, bitcoins are not legal tenders as they have not been issued by the Central Government or the RBI.

It may be noted that laws generally evolve slowly as compared to changes in the world and, hence, we are constrained to apply archaic laws to new business models. Before we reach any conclusion on the issue it would be worthwhile to understand whether bitcoins fulfill the characteristics of "money", even though they are not legally recognized?

Regardless of the form, money is traditionally associated with three different functions. First, money is a medium of exchange used as an intermediary in trade to avoid the inconveniences of a barter system. Second, money provides a unit of account. It acts as a standard numerical unit for the measurement of value of goods and services to make different offerings on the market more comparable. However, to serve as an efficient unit of account, a currency must be more than decimal and readily divisible. It must provide a measure of relative worth that users can understand on a nearly intuitive level, otherwise, users must expend time and effort to determine what the currency is and its associated unit of account really mean. Moreover, a currency can serve as an effective unit of account only if users accept its legitimacy. Third, currency serves as a store of value of current earnings for future spending. Non-circulating money can circulate in the future and that potential for future circulation represents wealth or value that an individual participant can take advantage of. It must also be noted that money in different forms is interchangeable without losing the absolute worth. As an example, money lying with bank can be converted into physical currency of equal amount.