Taxing the Crypto Transactions- Part 2

What is the issue?

In spite of the introduction of the Cryptocurrency and Regulation of Official Digital Currency Bill in Parliament, cryptocurrencies continue to proliferate.

For taxing the cryptocurrency part-1, click here

What are crypto assets?

- A crypto asset is a digital asset; but not all digital assets are crypto assets.
- The distinguish features of crypto assets:
  - uses cryptography
  - depends on distributed ledger technology
  - no need for a third party such as a bank to issue crypto assets
  - have three primary uses: as an investment, a medium of exchange, and to access goods and services.
- Crypto assets are commonly known as cryptocurrencies such as Litecoin, Ripple, Bitcoin, and Ethereum.

What are the existing provisions for taxing cryptocurrencies?

- A liberal estimate suggests that as many as 10 crore Indians may already have investments exceeding a total of 10 million dollars.
- Although the **Income Tax Act, 1961** does not specifically mention cryptocurrencies, it does made efforts to bring crypto transactions under its ambit.
- Trading in cryptocurrency may be classified as transfer of a ‘capital asset’, taxable under ‘**capital gains’**.
- If such cryptocurrencies are held as stock-in trade and the taxpayer is trading in them frequently, the same will attract tax under ‘**business income’**.
- Even if one argues that crypto transactions do not fall under the above heads, Section 56 of the IT Act shall come into play, making them taxable under the head ‘**Other sources of income’**.

What are the challenges in the process of taxing crypto transactions?

- **Absence of explicit tax provisions**- This has led to uncertainty and varied interpretations being adopted regarding computation, applicable tax head and tax rates, loss and carry forward, etc.
- There are divergent views in the market treating such an income as 'business income' or 'other sources of income', which are taxable at individual tax rate slabs.
- Arriving at the value of the crypto currency and how should such a transaction be taxed is also a question.
- **Identifying the tax jurisdiction**- It is tricky to identify the tax jurisdiction for crypto transactions as taxpayers may have engaged in multiple transfers across various countries.
- The cryptocurrencies may have also been stored in online wallets, on servers outside India.
- **Anonymity**- The identity of taxpayers who transact with cryptocurrencies remain anonymous as each crypto address comprises a string of alphanumeric characters and not the person's real identity.
- Tax evaders have been using the crypto transactions to park their black money abroad and fund criminal activities, terrorism, etc.
- **Lack of third party information**- The lack of third party information on crypto transactions makes it difficult to scrutinise and identify instances of tax evasion.
- Income Tax Department uses CASS or computer aided scrutiny selection of assessments, where returns of taxpayers are selected based on information gathered from third party intermediaries such as banks.
- However, crypto-market intermediaries like the exchanges, wallet providers, network operators, miners, administrators are unregulated and the tax authorities are forced to depend on the data provided by the taxpayers.
- **Tracing exchanges**- Even if the crypto-market intermediaries are regulated and follow Know Your Customer (KYC) norms, there remains a scenario, where physical cash or other goods/services may change hands in return for cryptocurrencies.
- Such transactions are hard to trace and only voluntary disclosures from the parties involved or a search/survey operation may reveal the tax evaders.

How can the challenges be addressed?

- **Legal framework**- The income-tax laws pertaining to the crypto transactions need to be made clear by incorporating provision of a definition for crypto assets followed by extensive awareness generation among the taxpayers.

- **Mandatory disclosure of tax returns**- A separate mandatory disclosure requirements in tax returns (the case in the USA) should be placed on the taxpayers as well as all the intermediaries involved, so that crypto transactions do not go unreported.
- **Strengthening the international legal framework**- The existing international legal framework for exchange of information should be strengthened to enable collecting and sharing of information on crypto-transactions.
- **Capacity building-** The Government must impart training to its officers in blockchain technology.
    - It may be noted that the UN Office on Drugs and Crime's 'Cybercrime and Anti-Money Laundering' Section (UNODC CMLS) has developed a cryptocurrency training module to equip tax officers to understand the underlying technologies.
- Tax authorities should equip themselves with the latest forensic software (such as **Elliptic Forensics Software** used in the USA and **GraphSense** used in the European Union) which can analyse and raise red flags in cases of suspicious transactions.

References

1. https://www.thehindu.com/opinion/op-ed/taxing-cryptocurrency-transactions/article38279469.ece