Taxing cryptocurrency transactions

(Mains GS 3 :2 & 3 : Government policies and interventions for development in various sectors and issues arising out of their design and implementation & Science and Technology- developments and their applications and effects in everyday life.)

Context:

> An estimate suggests that as many as 10 crore Indians may already have investments exceeding a total of $10 million in them which not only creates an avenue for generation of tax revenue for the nation but also puts forth a Herculean challenge for the tax authorities who have to track and tax transactions involving cryptocurrencies.

Wide enough net:

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

- However, this in itself is not sufficient in order to put in place a simple yet effective taxation regime for cryptocurrencies.

Varied challenges:

- Since cryptocurrencies are unlike any other asset class, stored and traded virtually, there are varied challenges which need to be addressed in order to streamline the process of taxing crypto transactions.
- The absence of explicit tax provisions has led to uncertainty and varied interpretations being adopted in relation to mode of computation, applicable tax head and tax rates, loss and carry forward, etc.
- For instance, the head of income under which trading of self generated cryptocurrency (currencies which are created by mining, acquired by air drop, etc.) is to be taxed is unclear.

Tax jurisdiction:

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

Anonymous identities:

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

Lack of information:

- The lack of third party information on crypto transactions makes it difficult to scrutinise and identify instances of tax evasion.
- One of the most efficient enforcement tools in the hands of the Income Tax Department is CASS or 'computer aided scrutiny selection' of assessments, where returns of taxpayers are selected *inter alia* based on information gathered from third party intermediaries such as banks.

- However, crypto-market intermediaries like the exchanges, wallet providers, network operators, miners, administrators are unregulated and collecting information from them is very difficult.
- Another consequence of this lack of information is that the tax authorities are left with hardly any tools to verify any crypto transactions which do get reported.

Hard to trace:

- 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.

Steps to be taken:

- While the aforementioned challenges provide enough food for thought to policymakers, certain steps can be taken to provide a robust mechanism for taxing crypto transactions going forward.
- To begin with, the income-tax laws pertaining to the crypto transactions need to be made clear by incorporating detailed statutory provisions.
- These could include provision of a definition for crypto assets for tax purposes and guidelines addressing the major taxable events and income forms associated with virtual currencies.
- This should be followed by extensive awareness generation among the taxpayers regarding the same.

Mandatory disclosure:

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

Training is important:

- The Government must impart training to its officers in blockchain technology.

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

Conclusion:

A streamlined tax regime will be essential in the formulation of a clear, constructive and adaptive regulatory environment for cryptocurrencies.