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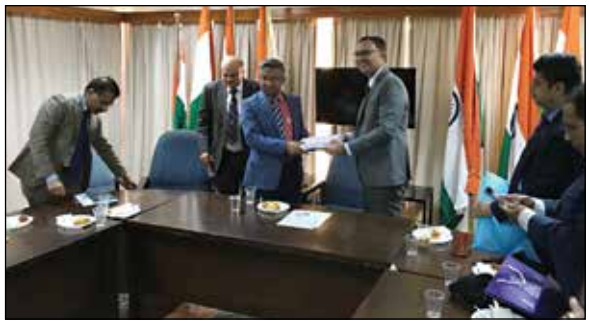
International Study Tour to Mauritius from 28th April, 2018 to 2nd May, 2018

Group Photo of delegates

The delegates visited Indian High Commission Office at Mauritius

Group Photo of delegates



Delegates with Mr. Dennis Seksum, Chairman and Mr. Patrice Tze, Executive Director, First Island Trust Company, Mauritius

Delegates with Mr. Abhay Thakur, High Commissioner of India and Mr. K. D. Dewal, Deputy High Commissioner of India

Crypto-currencies - Regulatory and Tax Issues

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1. BACKGROUND

Crypto-currencies have recently been in the spotlight and under the scanner of the tax authorities primarily due to the high prices at which they were seen trading on exchanges in India and around the world. However, the crypto-currency ecosystem is not all only about the various coins, such as bitcoins, but also includes several other actors and participants. Due to the rapidly evolving business models and complexity of the underlying blockchain technology, regulators and tax authorities are yet to come out with clear positions on various issues. This article attempts to raise questions that still remain unresolved, particularly from the perspective of not only the taxation of crypto-currencies themselves but also the manner in which other participants in the crypro-currency ecosystem are regulated and taxed. This article will also differentiate between a crypto-currency and a utility token which are often interchangeably used in common parlance even though they are fundamentally different with their own unique set of tax challenges.

2. THE PARTICIPANTS IN THE CRYPTO-CURRENCY ECOSYSTEM

The crypto-currency ecosystem broadly involves the miners, nodes, traders, crypto-currency exchanges, hash power rental companies, utility companies that issue tokens and the casual consumer/customer who invests into bitcoins. Briefly each of their roles are described below:

a. Miners: This is a term used to describe companies or individuals who use computing power to solve cryptographic problems generated by the blockchain software. When a miner is the first person to solve a particular cryptographic problem, then the miner is credited with a bitcoin by the blockchain software. For the sake of simplicity, the process of mining or solving the cryptographic problem should be understood to contribute toward the verification of a transaction that is conducted over the blockchain network, for instance, the transfer of a bitcoin from one wallet to another.

b. Nodes: This is the term used to refer to computing terminals that are part of the system of computing devices that run the blockchain software. Each node has a copy of the blockchain on it. Therefore, the blockchain system is also called a distributed ledger system as the entire record of transactions verified by the blockchain system is available in entirety on every node. The blockchain system is also considered significantly more secure than other softwares primarily because for any transaction to be verified and entered into the distributed ledger or blockchain, more than half the number of nodes connected to the system need to verify the transaction. Therefore, unlike traditional network where with increasing number of participants the network gets increasingly insecure, since each new person could be a source of a hack, the blockchain system gets increasingly secure as controlling more than fifty per cent of the nodes becomes more difficult. Historically, before blockchain became a famous phenomenon, individuals used to use their personal computers or even cell phones for the purpose of mining. However, with the surge in popularity of bitcoin and decreasing supply of mineable bitcoins, miners today use sophisticated hardware that is specially designed for this purpose which provides high end computing power.

c. Traders: Traders are individuals or companies that in the business of buying and selling bitcoins with the intention of making a profit.

d. Crypto-currency Exchanges: Crypto-currency exchanges act as online platforms that enable the traders and casual customers to buy and sell crypto-currencies. Exchanges perform the important function of market making as crypto-currencies tend to be illiquid in nature and if not for the market created or enable by exchanges trades would become significantly difficult for casual customers especially. Exchanges often allow either a crypto to crypto trade or crypto to fiat currency trade and *vice versa*. Most of the buying and selling happen between third parties, namely traders or consumers and it is only in very rare scenarios do the exchanges themselves own the cryptocurrency. Some exchanges have also accepted payments or service fees in bitcoins for enabling transactions on the exchange and therefore may be in possession of the same. However, as explained later below, due to the apprehension that ownership of bitcoins may lead to complications under the Goods and Services Acts (GST) or under the Income-tax Act, 1961 (ITA), most exchanges had shifted to operating a mere online platform for fees. Exchanges also self-regulated themselves and implemented stringent KYC norms while onboarding a customer. However, recently the Reserve Bank of India (RBI) has banned all institutions which fall under its regulatory framework from rendering services for any activity of virtual currencies.[1] This has caused severe hardship to exchanges and casual consumers who were conducting genuine trade activities. It is expected therefore that exchanges will shift operations abroad, which will result in a loss of revenue for the tax department.

e. Hash Power Rental Companies: Since mining operations require tremendous

1. *Prohibition on dealing with Virtual Currencies,* RBI Notification No.: RBI/2017-18/154 (6-4-2018), available at https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11243&Mode=0, (last seen on 9-4-2018).

amounts of electricity, they appear to usually be globally located in places where cheap electricity is available. In some instances, tax breaks or incentives could result in mining operations being conducted in certain places. Such companies invest money in buying specialized computer equipment that has been designed and manufactured for the purpose of mining bitcoins and then rent the computing power to other miners or third parties in exchange for fees. Therefore, irrespective of whether the miner is actually rewarded the bitcoin or not, the hash power rental companies receive their service fees. These activities should not be affected by the RBI ban mentioned above as their activities are akin to the provision of a cloud computing service or an online data storage place. The ban should not be applicable to them solely because their client uses their computing power towards the mining of bitcoins. Additionally, the concern for RBI while imposing the ban would have been the inability to possibly track cross-border flow of bitcoins and therefore exchange of money effectively, which should not be a concern in this case as the hash power rental company in India is only being paid service fees.

f. Utility Companies that issue Utility Tokens: Companies have taken to tokenization to popularize their products or services using terms and jargon similar to that of crypto-currencies. However, there is a significant difference between utility tokens and crypto-currencies. Utility token are issued by a company and therefore there is a counter party involved in the issuance process. On the other hand, cryptocurrencies are issued or granted to the miners by the blockchain software on the solving of the cryptographic puzzle. For a utility token, mere fiat currency would be sufficient to purchase such tokens without conducting any mining activity in most instances. Secondly, the utility token is usually redeemable or exchangeable for services or products offered by the issuing company in the future. The bitcoin does not have any such utility or inherent value and its value is more often dictated by the vagaries of demand and supply. Therefore a utility token is similar to a top up card that is used in food courts where the money is merely tokenized. The tokens in themselves may have a market as they are usually freely tradeable and therefore their value may go up, which is similar to bitcoins. However, once exchanged for services the tokens are consumed which is unlike bitcoins.

g. Casual consumer/customer: Initially participants in the early stages of the blockchain network were casual participants who undertook this as a hobby or side activity. Today, there are several individuals who are not traders but occasionally like to transact in bitcoins. The RBI ban has made it difficult for them to now sell the bitcoins they own and the prices have fallen as a result of the ban. Customers could also exchange bitcoins in return for any service or good, which is possible in countries like japan which have accepted bitcoins as a mode of payment. Prior to the ban, there was significant interest to undertake arbitrage trading where an individual would ideally want to purchase bitcoins outside India at a lower price and sell it within India where it was trading at a higher price at that point in time. However, the lack of clarity in the regulations and associated risks deterred many customers.

3. TAX AND REGULATORY ISSUES IN THE CRYPTO-CURRENCY ECOSYSTEM

Based on the above description, several tax and regulatory concerns for these parties are highlighted below based on the activities they undertake:

a. The RBI has not notified bitcoins or any other virtual currency as officially recognized currency till date and it look like an unlikely scenario. Usually fiat currencies are issued by a central bank or governmental authority and is backed by assets such as gold which are in the possession of the issuing entity. Bitcoin

being granted by the blockchain software does not meet those qualifications. Had bitcoin been classified as currency, the impact would have been that it is immediately out of the ambit of GST since 'goods' is defined not to include currency.

b. Under the Sale of Goods Act, 1930, property of any kind that is movable property would qualify as a good provided it is sold for monetary consideration. Therefore, arguably bitcoins are goods under this act only in crypto to fiat or fiat to crypto transactions and as such barter transactions are not recognized (which would in theory include crypto to crypto transactions). Extending the same logic if a person were to purchase other goods using crypto, such transactions would also not be covered by the Sale of Goods Act, 1930.

c. Under the ITA, capital assets are also defined to be property of any kind and is likely to cover bitcoins as well. The question then arises as to whether bitcoins could also qualify as stock-in-trade. Based on earlier clarifications by the Central Board of Direct taxes (CBDT) with respect to classification of shares as capital assets or stock-in-trade, it may be possible to take a view that a bitcoin sold by a casual consumer is a capital asset while a trader could possibly treat them as stock in trade. If it is treated as stock-in-trade then taxes would be payable on the consideration received under the head of business income.

d. Further, once a bitcoin is treated as a capital asset, depending on its period of holding, cost of acquisition and the sale consideration, capital gains should be payable at the time of sale. When consideration is received in fiat currency, there is no difficulty, however in barter transactions, valuation of the consideration could lead to issues or disputes. Further, cost of acquisition is may also prove a challenge when the bitcoin is not acquired from another third party. When a bitcoin is mined, there are no specific rules as to how the cost of acquisition should be calculated. In such a situation, it is possible that it may not be calculable and therefore no capital gains tax should be payable. Alternatively, the expenses incurred in setting up the mining equipment and the running expenses could be counted towards the cost of acquisition and improvement.

e. Even in situations where the bitcoin is acquired in exchange for services through a barter transaction, issues can be raised as to the value of the consideration received. As bitcoins are traded around the world at different rates and even intra-day prices could significantly differ, it is possible that this could also potentially lead to litigation.

f. With respect to hash power rental companies, their service fees would be the income that would be subject to income tax, but not the bitcoin that their mining operation generates since that would be deemed be the assets of the customer who has hired their services. Therefore, this situation should be similar to a company that does research and development for a third party under contract.

g. For individuals, especially those that had bought bitcoins using cash in the early days of bitcoin or non-resident Indians (NRI), the risk of being scrutinized is higher. When an NRI owns bitcoins outside India then there is no obligation to disclose the existence of the same in India. It is only when an NRI derives income from sale of assets in India that there is a requirement to disclose the same and pay taxes. However, if the NRI were to sell the bitcoins outside India and were to attempt to remit the money into India, since they would have made huge gains, chances are that it will be scrutinized closely. It may even be possible for Income Tax authorities to send notices, as they have in the past, asking about the source of income or the money and to show proof that it is not undisclosed income or black money. This could be a significant problem since at times it may be difficult to prove the manner in which bitcoins were acquired in the early days of the ecosystem. It is also tricky to establish that the bitcoin was located outside India since it is a locationless asset and the closest approximation of a location could be the

wallet on it was stored at the time of acquisition. However, it is possible that the consumers are not aware as to the location of the server on which the wallet is hosted in which case it could lead to litigation.

h. Similarly, for resident Indians who have bought bitcoins outside India, they are under an obligation to disclose foreign assets and money in their foreign bank accounts. Here again, the risks highlighted about with respect to source of funds and location of the asset could prove to be thorny issues even for genuine consumers. Should there be any default detected on their part the penalties could potentially be high.

i. GST should also be applicable to trades of crypto-currencies as the definition of goods is wide enough to cover intangible property including crypto-currencies. In such an event, when the bitcoin is sold for cash, there would be a single supply that should be subject to GST. Should the bitcoin be traded for another good, it should be considered a barter or in fact two simultaneous supplies and therefore GST would be payable twice resulting in a significant GST impact.

j. If the supply of bitcoin is by a consumer, but not in course of his business, for instance to buy icecream, then it should not a taxable supply under GST.

k. Being a locationless good, there are difficulties in determining whether it is an inter-State or intra-State supply of bitcoins. This would also impact whether the trades are across borders or not as well. The taxation and registration implications would differ significantly based on that.

l. Issues may arise in respect of exchanges as to the value on which GST is payable. Ideally it should only be on the service fee component charged by them, however, the tax authorities may take a different view on the matter.

m. While there is better clarity on hash power rental companies from a tax standpoint as they can be treated similar to any IT support services company, the Registrar of Companies may refuse to incorporate companies which mention crypto-currencies in the AOA or MOA, which could present a significant practical challenge. Additionally, banks may also choose to be conservative in interpreting the RBI ban and refuse to open a bank account for such companies.

n. Initial coin offerings, depending on the terms and conditions, could also amount to being securities in which case SEBI may scrutinize such transaction closely in the future.

o. Utility tokens are more akin to actionable claims as they represent a claim in relation to moveable property or services and therefore may not be taxable under GST which exempts actionable claims from GST, except for betting, gambling and lotteries. Such tokens, depending on the terms and conditions could also amount to a voucher under GST and if they do not qualify as an actionable claim, then the point of taxation is shifted to time at which the token is actually exchanged for services or goods.

4. CONCLUSION

The potential for blockchain technology is huge. It has the ability to be the backbone of India's digital infrastructure securing all the transactions made on the digital network. Keeping this is mind, it is clear that the technology is here to stay. Outrightly banning crypto-currencies is shortsighted and despite the complexities involved, there are sufficient benefits to consider regulating it and limiting misuse. Globally most countries have embraced it, while only countries with exchange control restrictions such as China or India have banned it. The ban imposed by RBI would be difficult to enforce in practice and as such, consumers lose value, exchanges lose business, the Government loses taxes, while most likely the trades will move either abroad or underground. This is a situation where all stakeholders lose and only way forward is to recognize the flaws of the current approach and take the steps necessary to regulate crypto-currencies in India.

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