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Are bitcoins currency or asset?

Income generated through regular trading in bitcoins would be considered "business income"

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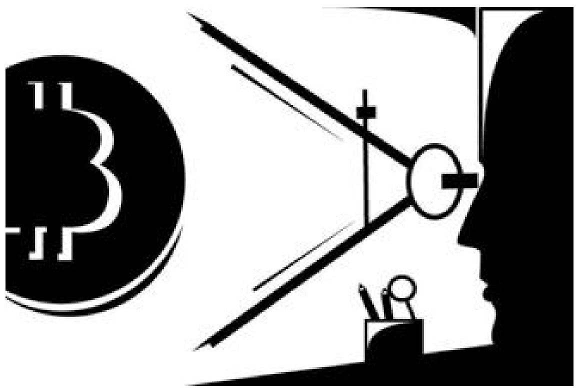

Shyamal Banerjee/Mint

When American online retailer Overstock.com opened its virtual gates to bitcoins on 11 January, it made around $130,000 in sales in one day, primarily from new customers, and left chief executive officer Patrick Byrne "#stunned". His prophecy that other online retail giants would follow suit was soon realized when reports that Ebay UK was contemplating a "virtual currency" category hit the news. These are arguably the surest signs that virtual currencies, and bitcoins in particular, are slowly but surely going mainstream.

The success of the bitcoin lies in the fact that it attempts to emulate the directness, transparency and security of peer-to-peer networks like BitTorrent in the monetary context. Money has traditionally been centrally regulated, and the sudden surge in bitcoins has invited mixed reactions from regulators across the globe. As Indian entrepreneurs have been jumping on the bitcoin bandwagon as well, all eyes are on the Reserve Bank of India (RBI), which is yet to come out with a definitive verdict. Pending this, it is also time to think about the tax treatment of bitcoins since transactions in the virtual currency are increasing in India.

While Indian tax authorities and laws are yet to respond to the bitcoin phenomenon, we may learn from the experience of other countries that have begun to think about the issues at play. There are two possibilities here that could impact the direct and indirect taxes payable, i.e., the characterization of bitcoin as either a "currency" or an "asset".

If bitcoins are treated as "currency" in India, income arising from the exchange of bitcoins for regulated currencies due to currency fluctuations should ordinarily be considered "income from other sources". However, income generated through regular trading in bitcoins would be considered "business income". Moreover, payments received in bitcoins would be considered "income" for each transaction involving goods and services. However, in India, "currency" has been understood restrictively to include coins, currency notes, bank notes, etc., and other such instruments issued by a governmental authority.

Most other jurisdictions regulating bitcoins have rejected their characterization as currency since they would not want to confer "money" status to peer-to-peer units. Consequently, several nations such as Singapore, Norway and Canada, have characterized bitcoins as "assets".

To understand the basis for this, we need to first stop and ask —what is a bitcoin? It is essentially a string of data created (or mined) by the computation of blocks in the system using appropriate software. The digitized nature of the bitcoin makes a stronger case for its characterization as an intangible asset. In India, such treatment would mean that virtual currencies, whether sold for cash or in exchange for goods or services, should attract capital gains.

However, this may not be the most elegant of approaches since several issues may arise. The transfer of bitcoins mined by the sender may be treated in the same manner as self-acquired intangible assets and may not be subject to capital gains tax. Exceptions have been carved out in case of certain transactions involving sale of self-generated assets, but virtual currencies are not included in that list.

Further issues may arise for financial institutions or traders since income from regular trade in bitcoins may be characterized as "business income". Another question that may arise is whether trading in bitcoins can be considered "speculative" business.

It may also be noted that sums such as payments to contractors and sub-contractors, the whole of which may not be characterized as income or profits in the hands of the recipient, may not be subject to withholding obligations where bitcoins are characterized as assets.

On the indirect tax front, one begins to wonder if payments made in bitcoins for goods and services should be considered barter transactions or payments in cash. If bitcoins are considered "currency", indirect tax implications should not arise. However, where bitcoins are considered assets, parties holding them may be compelled to convert to regulated currencies and indirect tax implications may arise.

In such a situation, while value-added tax (VAT) implications may arise on exchange of bitcoins for cash, VAT may not be applicable to purchase of goods using bitcoins since Indian VAT legislations contemplate only sale of assets for cash consideration and not on barter transactions.

Countries such as Germany and UK have, however, attempted to extend their VAT laws to bitcoin transactions and India may yet include barter transactions in goods within the newly proposed Goods and Services Tax regime. From a service tax perspective, since the legislation already envisages barter transactions, service tax should be payable on exchange of bitcoins for taxable services.

As of today, it may be safe to conclude that the present framework for taxation in India is sufficient for dealing with bitcoins and there are rational ways of applying tax laws to transactions in all cases depending on characterization. Although entities in the industry would prefer for bitcoins to be characterized as currency for tax purposes owing to the lighter tax burden, such characterization seems difficult in the present scenario. Thus, unless RBI proactively takes steps to recognize bitcoins as currency in an attempt to regulate them, it may be advisable for merchants accepting bitcoins as payment to treat them as assets for tax purposes.

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