THE WORLD OF VIRTUAL CURRENCY: BITCOIN IN INDIAN PERSPECTIVE

Written by ***Utsav Singhal***

5th Year BBA LLB Student, Amity University, Noida

INTRODUCTION

A crypto currency is a digital and virtual asset designed to work as a medium of exchange that uses strong secure financial transactions to control the creation of additional units and verify the transfer of assets. There are various kinds of digital, virtual and alternative currency.

Bitcoin is the first decentralized cryptocurrency, a form of an electronic cash. A digital currency without a central bank or single administrator that can be sent from user to user on the peer-to-peer Bitcoin network without the need for middle transactions. It was first released as open-source software by a pseudonymous software developer going by the name of Satoshi Nakamoto who introduced bitcoin in 2008. The intellect behind the idea was to create a medium of exchange being independent of any central authority that could be transferred electronically in a secure, verifiable and immutable way.

Blockchain is a public distributed ledger which maintains and records the transaction verified through cryptocurrency.[1] All confirmed transactions are included in the block chain. It allows Bitcoin wallets to calculate their spendable balance so that new transactions can be verified thereby ensuring they're actually owned by the spender.[2] The integrity and the chronological order of the block chain are enforced with cryptocurrency.[3]

Bitcoins have certain unique features[4] as compared to the modes of currency such as

    a) No intrinsic value

---

[1] Available at https://bitcoin.org/en/how-it-works
[2] *Id* at 1.
[3] Marc Pilkington,2016.
[4] Available at http://www.ijlemr.com/papers/volume2-issue7/30-IJLEMR-22360.pdf

b) No physical form

c) No central authority to control it

d) Decentralized setup

e) Use of secured blockchain network

f) Price determined on the average basis of all exchanges

g) Open source

h) Created and held digitally

i) Use of encryption technology

Working of Bitcoins [5]

The conceptual ideology behind the bitcoin's working is into three parts mainly,

- Cryptography
- Supply and Demand
- Decentralized Networks

Decentralized Networks

---

[5] Available at https://www.bitdegree.org/tutorials/how-does-bitcoin-work/
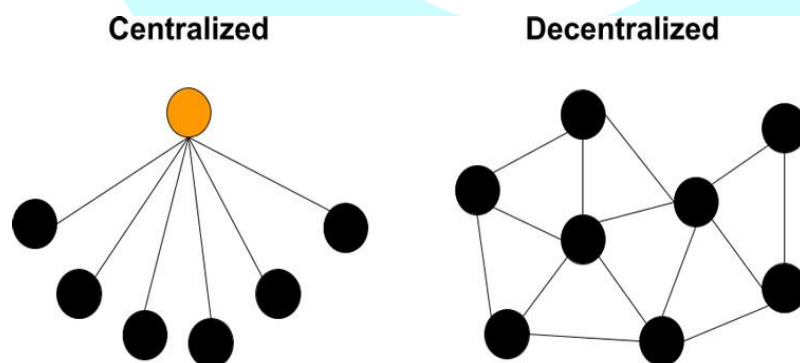
In a centralised network[6] is a type of network where all users connect to a central server, which acts as an agent for all communications and data. There is a mandatory centralized point. It is a client-server model.

In a decentralized network[7], the data is everywhere. A decentralized network can be identified using peer to peer connections rather than using a single point network access. The major difference between centralized and decentralized network is that the latter connects to different points or peers without having to go through a mandatory point.

Cryptography

Bitcoin uses cryptography to convert transaction data through mathematical formulas. Bitcoin does this using the blockchain technology.

Supply and Demand

The concept of supply and demand can be taken from Economics i.e. when the supply is limited, the demand increases and has more value.

The same concept applies to Bitcoins. The supply of bitcoin is limited to 21 million coins and are produced at a fixed rate. The demand is increased and the value increases.

TRADITIONAL TO DIGITAL CURRENCY: DIFFERENT FROM TRADITIONAL CURRENCIES

Bitcoin is a digital currency which can be used as an instrument of electronically. In a sense, it is like using traditional currency except is the bitcoins is traded digitally. However, in reality, the digital currency differs from the tradition currency in essential ways.

---

[6] Available at https://www.thewindowsclub.com/centralized-vs-decentralized-internet
[7] *Id* at 6.

Decentralization

Bitcoin's most important characteristic is that it is decentralized. No single institution controls the bitcoin network.[8] It is kept by multiple voluntary coders and runs by an open network of dedicated computers spreads far and wide. This pulls in individuals and gathering that are awkward with the control that banks or government organizations have over their cash.

Bitcoin solves the "double spending problem" of electronic transactions through a perfect blend of cryptography and economic motivations. The trustworthiness of the transactions is maintained by the disseminated and open system, owned by nobody.

Limited supply

Traditional currencies such as dollars, euros, yen, etc have an unlimited supply. The central authorisations and banks can issue as much currency required and manipulate currency's value relative to others.

On the other hand, bitcoin has a limited supply which is tightly controlled by the mathematical algorithm. A small number of bitcoins trickle out every hour and will continue to do so until a maximum of 21 million has been reached making it more attractive as an asset. Keeping in mind the theory of economics of supply and demand, if demand grows and the supply remains the same, the value will increases.

Immutability

Bitcoin transactions cannot be reversed or returned. Once the investment has been recorded as a transaction on the network, it cannot be modified. This means that the transactions on the bitcoin network cannot be tampered with.

Values and Regulations

The value of bitcoin varies day to day. There are more than $2 billion dollars' worth of bitcoins in existence. Bitcoins will stop being created when the total number reaches 21 billion coins.[9] As of 2018, more than half of those bitcoins had been created.[10] The currency itself is self-

---

[8] Available at https://www.coindesk.com/information/what-is-bitcoin/
[9] Available at https://www.lifewire.com/what-are-bitcoins-2483146
[10] Available at https://en.wikipedia.org/wiki/Bitcoin

contained and uncollateralised, meaning that there is no precious metal behind the bitcoins; the value of each bitcoin resides within each bitcoin itself.

BITCOIN IN INDIA

There is a growing demand for Bitcoins in India especially after the demonetization of Indian currency. With the increasing knowledge and understanding of the digital currency, the rules and regulations controlled by the RBI applicable to Indian currency should also be applicable to bitcoins.

As per Indian constitution, article 246 gives the list of all activities that are legislated by central and state government.[11] Entry 36 and 46 of List I of the Seventh Schedule of the Constitution[12] states that the Central Government is allowed to legislate in respect of currency, coinage, legal tender, foreign exchange and bills of exchange, cheques, promissory notes and other like instruments respectively.[13]

If Bitcoin falls any of the categories of being currency, coinage, legal tender, foreign exchange and bills of exchange, cheques, promissory notes and other, the central government would have exclusive power to legislate.

The principal laws concerning Indian currency are:

- The Constitution of India, 1950;
- The Foreign Exchange Management Act, 1999 ("FEMA");
- The Reserve Bank of India Act, 1934 ("RBI Act");
- The Coinage Act, 1906 ("Coinage Act");
- The Securities Contracts (Regulation) Act, 1956 ("SCRA");
- The Sale of Goods Act, 1930 ("Sale of Goods Act");
- The Payment and Settlement Systems Act, 2007 ("Payment Act").

---

[11] Available at https://indiankanoon.org/doc/77052/
[12] Available at https://www.mea.gov.in/Images/pdf1/S7.pdf
[13] Available at https://www.thelordsconsultancy.com/single-post/2018/03/09/Bitcoins--A-Global-Perspective-Indian-Legal-and-Tax-Considerations-By-TLC

- Indian Contract Act, 1872 ("Contract Act")

These laws will become applicable to Bitcoin if RBI wants to treat it as a currency.

Is Bitcoin a Currency?

The FEMA, RBI and the Coinage Act are the three statutes that together define and regulate the issuance, utilization, and disposal of currencies.

The RBI Act doesn't define currency in the statute. However, FEMA statute has defined currency to include, 'all currency notes, postal notes, postal orders, money orders, cheques, drafts, travellers cheques, letters of credit, bills of exchange and promissory notes, credit cards or such other similar instruments, as may be notified by the Reserve Bank.'[14]

There is no definition for legal tender under Indian law, the power to issue bank notes vests exclusively with the Reserve Bank of India. The bank note issued by RBI is considered legal tender.[15] It could be argued that so far as Bitcoin is not specifically designated by the government to be legal tender, should not fall within this category.

The term currency notes are specifically defined in Section 2(i) of FEMA[16] to mean and include cash in the form of coins and banknotes. Bitcoins are not issued or covered under the definition provided in the Coinage Act or RBI Act.

However, the question at hand is whether a 'virtual currency' as Bitcoin can come under the purview of the definition of currency.

Relying on the Supreme Court cases in Shankara Rao Badam & Ors. v. State of Mysore & Anr.[17] and Union of India & Anr. v. Tulsiram Patel[18] in light of the provisions of the law, it has been reasonably concluded that 'virtual currency' should be considered excluded from the definition of currency. No other declaration in the relation of cryptocurrencies has been made by the courts or any other concerned regulatory. However, RBI has merely advised the public

---

[14] Section 2(m) of The Foreign Exchange Management Act,1999
[15] S. 26 of RBI Act
[16] FEMA 1999, Available at
https://dor.gov.in/sites/default/files/Foreign%20Exchange%20Management%20Act%201999.pdf
[17] 1969 AIR 453; https://indiankanoon.org/doc/44591/
[18] 1985 AIR 1416; https://indiankanoon.org/doc/1134697/

to be cautious regarding the trading of virtual currencies. [19] From the provisions of existing law, it can be concluded that Bitcoins are not currency.

Keeping in mind the definitions provided by the legal statutes it appears that while Bitcoin has several features of a currency or legal tender, it is not a banknote and is consequently not legal tender in India.

The question which comes next if not currency then is "virtual currency" a commodity or goods?

Under the Indian Law, the term commodity has not been defined in the provided statutes. In the case of Tata Consultancy Services V. State of Andhra Pradesh[20], Hon'ble Justice Sinha concurring with the court's view stated that a commodity is generally understood to mean goods of any kind, something of use article of commerce. Since Bitcoins are an intangible asset, there is a possibility of being characterized as a commodity.

Bitcoins fall well within the meaning of "goods" as provided by the Sale of Goods Act. The act defines "goods" under Section 2 (7) of the Act as "every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale."[21]

Regulatory Concerns Regarding Bitcoins

RBI has adopted a hands-off policy in relation to Bitcoins. RBI has cautioned the public regarding the trading of virtual currencies and approach towards the regulation of bitcoins. However, there has been a growing need for a regulatory policy regarding cryptocurrencies specifically Bitcoin.

The creation, trading or usage of virtual currency including Bitcoin such as medium for payment is not recognized by the central bank or any monetary authority. No regulatory

---

[19] RBI Press Release, "RBI cautions users of Virtual Currencies against Risks", 24 December 2013.Available at: http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=30247
[20] Appeal (civil) 2582 of 1998
[21] Section 2 of the Sale of Goods Act; https://www.lawctopus.com/academike/goods-under-the-sale-of-goods-act-1930/

approvals, registration or authorization is to be given or to be obtained by the entities carrying on activities.

Know Your Customers Norms: Applicable to Bitcoins

In India, KYC Norms are the norms set by the RBI that require banks to continuously monitor their customers' transactions, keep an up-to-date record of their identity, and take steps simply in case any of the transactions of a customer break from his or her usual pattern of behavior.[22] The system of Bitcoin uses the blockchain technology to keep a proper and systematic track of the transactions that are being made in relation to the transactions of bitcoins. As established that Bitcoins are not currency or legal tenders under Indian legal statutes. However, KYC requirements are being followed by some Bitcoin exchanges before allowing customers to open accounts with them.[23]

Section 3[24] of the Prevention of Money Laundering Act, 2002 will lose its purpose if the authorities are not able to identify the person, making the investigation involving money laundering much more difficult. RBI has mandated that the financial institutions, banks and intermediaries collect all information of their respective clients under the KYC norms. [25]

Due to the lack of physical presence of bitcoins and anonymity what it creates for the users. If the KYC norms are not regulated under the existing legal and regulatory framework it would be in clear violation of the prevention of Money Laundering Act, 2002.

Cross border transfer of Bitcoin

FEMA regulates all foreign exchange related transactions i.e. inbound as well as outbound transactions. Section 3 of FEMA[26] states that other than as provided, no person shall: 'deal in or transfer any foreign exchange or foreign security to any person not being an authorized person;

---

22 Available at https://Bitcointalk.org/index.php?topic=454795.0
23 Section 12 of the Prevention of Money Laundering Act, 2002
24 Section 3: Offence of money-laundering: Whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of offence of money-laundering.
25 Section 45 IA of Reserve Bank of India Act, 1934
26Section 3 of FEMA; https://indiankanoon.org/doc/165125/

i.   make any payment to or for the credit of any person resident outside India in any manner;

ii. receive otherwise through an authorized person, any payment by order or on behalf of any person resident outside India in any manner; and

iii. Enter into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire, any asset outside India by any person.'

Thus, can be argued that purchasing of Bitcoin by a resident Indian from a person resident outside India where the money transferred through legitimate banking channels will not be in violation of FEMA. Further, Bitcoin transaction between two residents should also not trigger FEMA and should not, therefore, be in violation of the same. However, the sale of Bitcoin to a non-resident person in India by a resident Indian will be in violation of the provisions of FEMA. Further, regulated by RBI under such circumstances. [27]

Taxation

Article 246 of the Indian Constitution confers powers related to legislation of tax rules to state as well as central legislatures. Schedule VII enumerates these subject matters in 3 separate lists. Taxes are applicable to income or expenditure.

When taxation is on income, it may be on Bitcoin representing such income or on Bitcoin representing asset value.[28] Additionally, it may also be on expenditure – the cost of acquiring Bitcoin, such as Central Sales Tax, Value-Added Tax or Service Tax. [29]

For the purpose of taxation, three major scenarios emerge:

i.   mining of Bitcoin (similar to self-generated goodwill),

ii. transfer of Bitcoin (where Bitcoin are either a capital asset or a stock-in-trade depending on the activity undertaken by the taxpayer), and,

---

[27]Available at http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20Papers/Bitcoins_A_Global_Perspective.PDF

[28] Available at https://www.thelordsconsultancy.com/single-post/2018/03/09/Bitcoins--A-Global-Perspective-Indian-Legal-and-Tax-Considerations-By-TLC

[29] *Id.*

iii.   Transfer of Bitcoin as consideration (where Bitcoin are either a capital asset or a stock-in-trade, depending on the activity undertaken by the taxpayer).

Income Tax

Taxation of income in India is governed by the provisions of the Income Tax Act, 1961 ("ITA"). Under the ITA, residents are subject to tax in India on their worldwide income, whereas non-residents are taxed only on income sourced in India. However, non-residents, who are resident of a country with which India has signed a tax treaty, have the option of being taxed as per the tax treaty or the ITA whichever is more beneficial. Every person, who is an assessee and whose total income exceeds the maximum exemption limit, should be chargeable to the income tax at the rates prescribed.[30]

Bitcoin can be considered as currency or a capital asset. Under Indian law, bitcoins makes it difficult to conclude as to how it may be taxed.

RISKS RELATED TO BITCOINS

The risks related to bitcoins are:

- Cyber Attacks and Hacking: "Virtual Bank Robbery"

  Cyber Thieves are attacking the bitcoin community repeatedly. These attacks decline the value of the currency. Cybersecurity becomes a constant concern. Due to the lack of confidence in Bitcoin and hence lack of insurance, there is no sign of consumer protection in the Bitcoin community.[31]

- Price Fluctuation and Inflation

---

30 Available at https://www.taxmann.com/income-tax-acts.aspx
31 Nicholas A. Plassaras, 'Regulating digital currencies: Bringing Bitcoin within the reach of the IMF', Forthcoming, 14 Chi J intl L _ (2013) Pg. 12.

Businesses and merchants avoid using Bitcoins as newness and volatility of value is extremely high.[32] This leads to uncertainty and reduces confidence in the currency.

- Fraud

Bitcoins are anonymous in nature, which opens an oversight for fraudsters. It becomes easier for fraudsters giving them access to privacy[33] and harming the customers personally, which leads to decline in the value of the currency as well as the damage the economy to a great extent.

- Uncertainties in the Government Policies

The government has been inconsistent with the policies. The major issue regarding bitcoins is that government might come around virtual currency and declare in illegal to work around, leaving the investors without any legal remedy and helpless.

CONCLUSION

Bitcoin is unique as a virtual currency. The uniqueness is not just restricted to the virtualness but also as the concept of bitcoin is of decentralized non-issued electronic currency. Any new currency introduced faces a lot of challenges to secure acceptance amongst the regulatory systems and society. Bitcoin is a major step towards virtual currency but is not a fiat currency. It has a number of weak spots and viability concerns. To succeed even as virtual currency, there needs to be some regulatory or governmental backing which bitcoin lacks. It might and can succeed in the upcoming time building on the lessons and experience from bitcoin but as now the Bitcoin is being declared illegal in many parts of the worlds.

---

32 Joshua Davis, Department of Technology 'The Crypto-Currency', The New Yorker (10 October 2011) Pg. 68

33 US Securities and Exchange Commission's Office of Investor Education and Advocacy, 'Investor Alert (Ponzi Schemes Using Virtual currencies "http://www.sec.gov/investor/alerts/ia_virtualcurrencies.pdf" accessed 07/01/2015.

Analysing the situation in India, virtual currencies are gaining a lot of hype and publicity, thus a cause of concern as bitcoin no legal backing, some exchanges have started operating from platforms like Zebpay, Coinsecure, and Unocoin etc. Bitcoins have also gained significant popularity after demonetization under the Modi Government. The Government of India should recognize the opportunity which Bitcoin brings as virtual currency and harness this opportunity for the social and economic betterment. Bitcoin can help in the decentralization of economic power, have a larger financial access further breaking down the socio-economic barriers.

However, there is upside and downside to bitcoin as it is a saying a coin always has two sides. The greatest challenge for regulators is to classify Bitcoin as currency or commodity. If this is classified as a currency, probably RBI will play a leading role in its regulation. If Bitcoin is treated as a commodity, SEBI will initiate regulations. Secondly, the decentralisation and anonymity creates a lot of risk factors dealing with trading of bitcoins. The finance minister during his budget speech on February 01, 2018 has made it very clear that the cryptocurrencies are not recognized as legal tender in India and issued a warning regarding the same.