

## Bitcoins - Legal or illegal in India?

### Introduction

Bitcoin is a cryptographic, digital and experimental currency introduced in the digital world in 2008. It is referred to as a “peer-to-peer, electronic payment system”. Unlike the usual form of currency, it is in virtual form and can be used to make payments online as well as in physical stores. With the enormous increase in the usage of internet and transactions through digital mode, creation of a digital currency was inevitable. However, certain questions arise i.e. whether it is a safe form of currency, if bitcoin has been accorded legal recognition and accepted as a digital currency and is regulated or not. Though a few countries like US have started regulating bitcoins, in India, it remains unregulated as the central regulatory bank, the Reserve Bank of India (“**RBI**”) is currently keeping a vigil on this virtual currency that is gaining popularity among internet users, but has not shown inclination of regulating it.

In light of the above, this newsletter attempts to examine the concept of bitcoins (*virtual currency*) and throws light on the legality, use and risks involved with bitcoins.

### 1. The basics of bitcoin

Essentially, bitcoin is a snippet of codes based on algorithm first identified in a self authored paper by Satoshi Nakamoto (*a fictitious name for a group of geeks*). The creation and transfer of bitcoins is based on open source cryptographic protocol managed in a decentralized manner. Bitcoin network shares a public ledger called the “*block chain*”. The ledger contains details of every transaction processed, thereby, allowing user’s computer to verify the validity of each transaction. The authenticity of each transaction is protected by digital signatures corresponding to the sending addresses, permitting all users to have full control over sending bitcoins from their own bitcoin addresses. Anyone can process transactions using the computing power of specialized hardware. This process is called “mining”.

Bitcoins are listed on stock exchange. Presently, the largest exchanges are: (i) BTC China; (ii) Mt. Gox in Japan; (*most widely used*) (iii) BitBox in U.S.; (iv) Bitstamp in Slovenia; and (v) Bitcurex in Poland. At present, India does not have a centralised bitcoin exchange, but users can buy and sell coins through several websites. Around 23,000 India users have online bitcoin wallet where their digital currency is stored.

### 2. Legal position in India

At present, there are no regulations governing virtual currencies like bitcoins in India. RBI, on December 24, 2013, issued a press release on virtual currencies like bitcoins, litecoins, bbqcoins, dogecoins stating that creation, trade and usage of virtual currencies as a medium for payment is not authorized by any central bank or monetary authority. Further, RBI has cautioned virtual currency traders and users to various security related risks such as hacking,

malware attack etc. While RBI has not legalized bitcoins, it has declared them unauthorized as of now. RBI is currently examining the risks associated with the usage, holding and trading of virtual currencies under the extant legal and regulatory framework of India, including foreign exchange and payment systems laws and regulations.

## 2.1 Risks

According to RBI, virtual currencies being in digital form are stored in digital/electronic media that are called electronic wallets (*e-wallets*). Therefore, they are prone to losses arising out of hacking, loss of password, compromise of access credentials, malware attack etc. Since they are not created by or traded through any authorized central registry or agency, the loss of an e-wallet could result in the permanent loss of the virtual currencies held in them. Payments made through virtual currencies, such as bitcoins, takes place on a peer-to-peer basis without an authorized central agency regulating it. As such, there is no established framework for recourse to customer's problems/disputes/charge backs, etc. Further, there is no underlying or backing of any asset for virtual currencies. The value of bitcoin seems to be a matter of speculation. Since virtual currencies are volatility in nature, users are exposed to potential losses on account of such volatility. It is reported that virtual currencies are being traded on exchange platforms set up in various jurisdictions whose legal status is also unclear. Hence, the traders of virtual currencies on such platforms are exposed to legal as well as financial risks. There have been several media reports of the usage of virtual currencies, including bitcoins, for illicit and illegal activities in several jurisdictions. The absence of information of counterparties in such peer-to-peer anonymous/pseudonymous systems could subject the users to unintentional breaches of anti-money laundering and combating the financing of terrorism.

## 2.2 Scope

As mentioned above, bitcoins are not authorized as yet but there is scope for them to be legalized under different legislations. As per the Foreign Exchange Management Act, 1999, currency is defined as “*all currency notes, postal notes, postal orders, money orders, cheques, drafts, travelers 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.*” According to the definition, RBI has the power to include bitcoins within the definition of currency. Currency other than “Indian currency” is termed as “foreign currency”, and regulated by foreign exchange laws. Most likely bitcoins can be governed by foreign exchange laws. Further, Bitcoins can also be included within the definition of “security” which states that “**such other instruments as may be declared by the Central Government to be securities**”. Further, the Indian Copyright Act, 1957, defines the term “computer programme” as “*a set of instructions expressed in words, codes, schemes or in any other form, including a machine readable medium, capable of causing a computer to perform a particular task or achieve a particular result*”. Having gone through the various definitions, it can be concluded that there is enough scope for legalizing bitcoins. One has to wait and watch as to which approach the Indian government takes.

### 2.3 Bitcoin transactions

HighKart.com became the first e-commerce site in India to exclusively accept bitcoins as a payment method. WERWIRED, a Bangalore-based geospatial, security and entertainment consulting company offered bitcoins as a mode of payment for its customers. Castle Bloom, a salon in Chandigarh, became the first physical outlet to start accepting the digital currency. Buysellbitco.in, an online portal dealt in buying and selling of bitcoins in India. But it was raided by the Enforcement Directorate. The preliminary investigations found it to be in violation of the foreign exchange laws. Post the RBI press release, traders and customers have become cautious as to avoid the use of bitcoins until it is legalized.

If bitcoins are used in transaction, the question that arises is can bitcoin be regulated under the Sale of Goods Act. Price is an essential element of a contract of sale. Barter forms an exception to the transaction of sale of goods. This means that any transaction where payment is made in bitcoins would come within the category of “barter” and would not be governed by the Sale of Goods Act. So, such a transaction will not be enforceable in India. But, a transaction which follows the tenets of contract law, remains completely within India and for a lawful consideration and not opposed to public policy can be considered legitimate. Though the tax aspect of bitcoins is also a grey area, in order to comply with the income tax regulations, a person accepting bitcoins against services should pay income tax after converting bitcoins into rupees and the bitcoin sellers who earn profit can pay capital gains tax (*if selling after a long duration*). Such steps will legitimize the unregulated bitcoins transactions.

### 3. Legality of bitcoins in various jurisdictions

Countries like Australia, United States, Canada etc. have legalized bitcoins operations within their territories. While countries like China, Japan etc. have adopted a restrictive approach. China has restricted only financial institutions from dealing directly in bitcoins without making it illegal.

In November 2013, the United States Senate held a committee meeting to discuss virtual currencies. It was stated that bitcoin is a legal means of exchange and that online payment systems, both centralized and decentralized, offer legitimate financial services. Further, the Internal Revenue Service (“IRS”) made its position clear on bitcoin in March 2014 stating that it will consider bitcoin a form of “property” rather than a currency. Thus, every bitcoin transaction would be considered as capital gain and accordingly taxed.<sup>1</sup> The IRS also announced that bitcoin mining activity would be taxed as income on the basis of fair market value as of the date of the specific activity, and that all of the foregoing guidance would be applied retroactively.

Monetary Authority of Singapore intends to regulate bitcoins on similar guidelines as those applicable to money changers and cash transactions. Regulations will require the

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<sup>1</sup>As per information available on [http://www.irs.gov/pub/irs-drop/n-14-21.pdf?utm\\_source=3.31.2014+Tax+Alert&utm\\_campaign=3.31.14+Tax+Alert&utm\\_medium=email](http://www.irs.gov/pub/irs-drop/n-14-21.pdf?utm_source=3.31.2014+Tax+Alert&utm_campaign=3.31.14+Tax+Alert&utm_medium=email), last visited on April 14, 2014

intermediaries that buy, sell or facilitate exchange of virtual currencies for real currencies to verify the identities of their customers and report suspicious transactions to the Suspicious Transaction Reporting Office. However, investors in virtual currencies will not enjoy the safeguards that investors in securities do under the Securities and Futures Act and the Financial Advisers Act. Likewise, Canada has also made transactions through bitcoins taxable.

## Conclusion

Though the use of bitcoins is gaining momentum around the world, there are a number of issues which remain unanswered:

1. Is bitcoin an investment?
2. Can it become a viable currency?
3. Can other “cryptocurrencies” compete with or supplant bitcoin?

Since use of bitcoin involves high level of risks, unless ambiguity surrounding bitcoins is resolved its use cannot be foolproof.

In summation, bitcoins are digital cash and decentralized, peer-to-peer payment system. Being volatile in nature, care has to be taken that a mechanism is devised to tackle risks associated with fraud and money laundering. Regulators will have to take steps to provide individuals and businesses with rules to integrate this new technology with the formal regulated financial systems. In general, bitcoins have a number of benefits, it significantly reduces transaction costs, enables the growth, ease and security of e-commerce and physical transactions, etc. Keeping pace with the changing times, Indian government will have to come out with appropriate amendments in the foreign exchange and information technology laws to specifically include bitcons.

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