



Management

## AN ANALYTICAL STUDY OF PRESENT POSITION OF BITCOINS

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DOI: <https://doi.org/10.29121/granthaalayah.v5.i1.2017.1913>



### Abstract

Bitcoin is a virtual currency that is created from computer code. It has no central bank and is not backed by any government. But it can be exchanged for goods and services or for any other currencies. They were launched in 2009 as a bit of software written under the name Satoshi Nakamoto. The present paper analyse the Indian Tax and legal considerations regarding Bit coins. It also analyse the problems and risks related with Bitcoins.

**Keywords:** Bitcoins; Virtual Currency; Cryptocurrency.

**Cite This Article:** Dr. Alka Mittal. (2017). “AN ANALYTICAL STUDY OF PRESENT POSITION OF BITCOINS.” *International Journal of Research - Granthaalayah*, 5(1), 386-394. <https://doi.org/10.29121/granthaalayah.v5.i1.2017.1913>.

### 1. Introduction

Bitcoin is a cryptocurrency which is a form of payment that uses cryptography to control its creation and management, rather than relying on central authorities. According to Nakamoto, Bitcoin is a software-based online payment system and introduced as open-source software in 2009. It is also considered to be the world's first decentralized currency, in virtual form and may be used to transact in physical as well as online transactions. The concept of Bitcoin was developed by Satoshi Nakamoto. Bitcoin is a peer-to-peer digital system of payment. As Satoshi Nakamoto, the creator of Bitcoin puts it – “an electronic cash system”. Payments are recorded in a public ledger using its own unit of account. The system was intended to be set up in a way where the difficulty of mining every next Bitcoin is greater than the previous one. The final Bitcoin will be mined in the year 2140, at the current rate.

There are three primary ways to obtain Bitcoin:

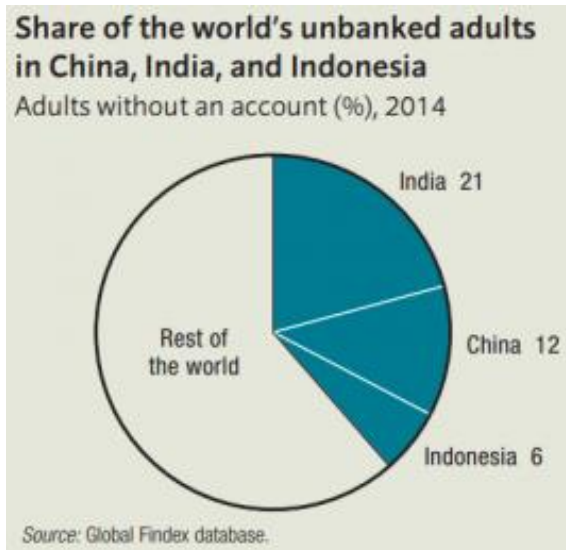
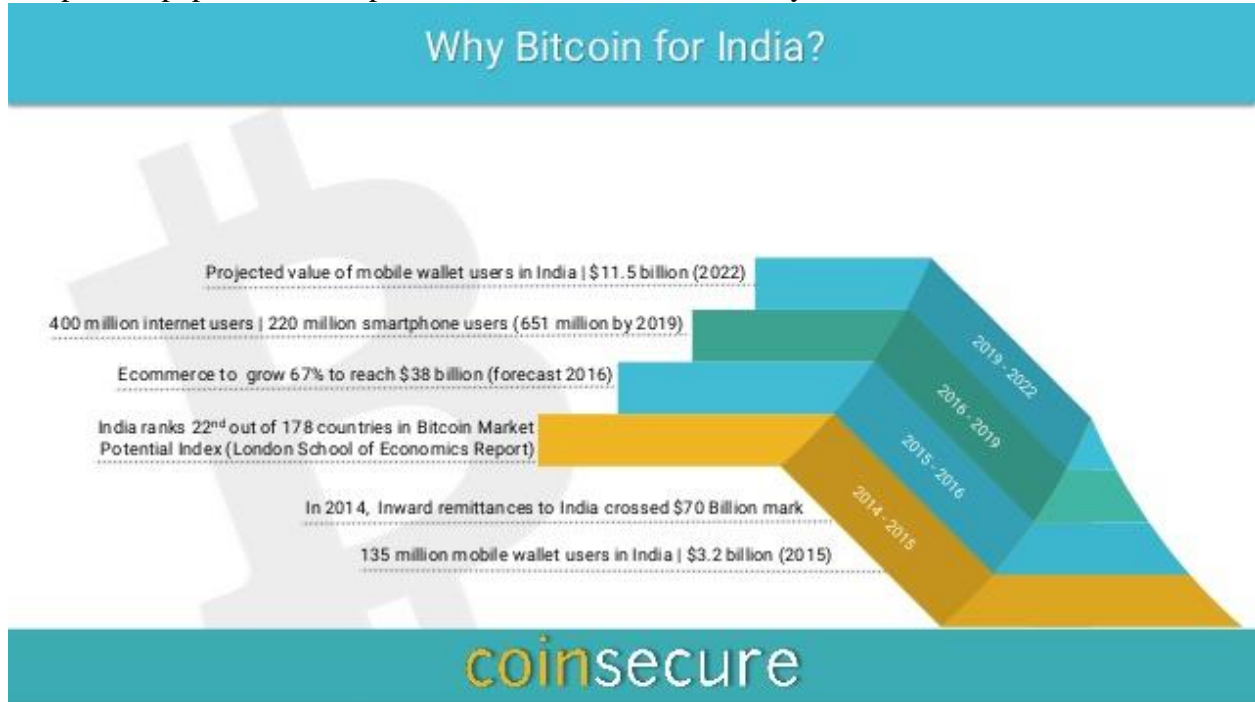
- i. mining new ones.
- ii. buying on an exchange; and
- iii. accepting them for goods and services.

## 2. Objectives of the Study

- 1) To understand the concept of Bitcoins
- 2) To know the Indian Legal and Tax Considerations regarding Bitcoins
- 3) To analyse the problems of Bitcoins
- 4) To know the risks related with bitcoins

## 3. Research Methodology

The present paper is a descriptive research based on secondary data.



#### 4. Indian Legal and Tax Considerations

There are a growing number of businesses and individuals using cryptocurrencies like Bitcoin. These include brick and mortar businesses like restaurants, apartments, law firms, and popular online services such as Namecheap, WordPress, Reddit and Flattr. While cryptocurrency remains a relatively new phenomenon, it is growing fast. Bitcoin is steadily increasing in popularity as an accepted currency all around the world. Several vendors and marketplaces now accept Bitcoin as a mode of payment. This trend holds particularly true for vendors who accept micropayments, such as payments for digital music downloads. Such vendors value the use of Bitcoin to avoid the transaction costs associated with traditional electronic payment methods. Many other vendors do not accept Bitcoin directly, rather, they use an intermediary to accept Bitcoin payments and convert it into a standard currency. In short, Bitcoin has become a popular method of transacting with vendors of goods and providers of services. Bitcoin is also growing rapidly in the area of online gambling. The growing use of Bitcoin as a standard currency gives rise to a host of potential income tax and other regulatory issues. Unfortunately, the current state of the law fails to provide insight as to what the proper treatment of these Bitcoin transactions should be. One of the ways to classify virtual currencies is to study its interactions with the fiat money in circulation. This can happen in two ways:

- a. currency flow through exchanges; and
- b. flow of currency due to purchasing and sale of real goods and services.

The following three types of schemes can be distinguished on this basis:

*i. Closed virtual currency scheme:*

This type of scheme has minimal link to the actual economy and is occasionally called “in-game only” scheme. In this scheme, a subscription fee is paid by the user to earn virtual currency by performing specified online tasks. This currency can only be used to buy virtual goods and services within such community.

*ii. Virtual currency schemes with unidirectional flow:*

In this scheme real currency is used directly to purchase the virtual currency at a specified rate (exchange rate). Real goods and services may be bought in such a scheme using the virtual currency.

*iii. Virtual currency schemes with bidirectional flow:*

In this case the virtual currency resembles any other currency capable of exchange. The currency can even be bought and sold according to the set exchange rates. Real as well as virtual goods and services can be bought and sold through this currency. Bitcoin and most other currencies follow this scheme.

The principal laws concerning Bitcoin are:

- i. The Constitution of India, 1950;
- ii. The Foreign Exchange Management Act, 1999 (“FEMA”);
- iii. The Reserve Bank of India Act, 1934 (“RBI Act”);
- iv. The Coinage Act, 1906 (“Coinage Act”);
- v. The Securities Contracts (Regulation) Act, 1956 (“SCRA”);
- vi. The Sale of Goods Act, 1930 (“Sale of Goods Act”); and
- vii. The Payment and Settlement Systems Act, 2007 (“Payment Act”).
- viii. Indian Contract Act, 1872 (“Contract Act”)

## 5. FEMA, RBI and Coinage Act

The three statutes together define and regulate the issuance, utilization and disposal of currencies (and money). The terms legal tender and bank notes have not been clearly defined in any of the three aforementioned statutes. However, from an analysis of the provisions of the relevant regulatory statute, the nature and characteristics of the terms legal tender and bank notes have been determined.

### Virtual Currency

The question at hand is whether a ‘virtual currency’ such as Bitcoin can be said to come under the purview of the definition of currency above. The answer to this question can be found in the maxim ‘express um facit cessare tacitum’. The maxim represents the principle ‘when there is express mention of certain things, then anything not mentioned is excluded’. The maxim has been recognized by Indian courts

### Bitcoin as Payment System or Pre-Paid Instrument

The RBI regulates and supervises the payment systems in India under the Payment Act. Bitcoin, though often referred to as the peer-to-peer payment system, cannot clear or settle the payment between the payer and the beneficiary. Thereby it is not to be treated as a ‘payment system’ under the Payment Act.<sup>114</sup>

In India, pre-paid instruments are regulated by RBI in pursuant of its power conferred under the provisions of Payment Act.<sup>115</sup> The directions issued by RBI stipulate that a pre-paid instrument can be used to discharge any payment obligation equivalent to the value attached to it.<sup>116</sup> On the other hand, Bitcoin need not be traded to discharge payment obligations equivalent to its value. Since the value of a Bitcoin are determined by market speculation, it can be either less or more than the payment obligation it is traded for.<sup>117</sup> Therefore, it cannot be said that the value stored in the instrument represents the value paid by the holders.

The maximum value of these pre-paid payment instruments cannot exceed INR 50,000 with a minimum validity of six months from the date of activation or issuance to the holder.<sup>119</sup> Banks that comply with the eligibility criteria are authorized to issue three kinds of pre-paid payment instruments and Non-Banking Financial Companies (“NBFC”) and other persons have been authorized to issue only semi-closed system payment instruments. This infers that the issuer of a pre-payment instrument needs to be either a bank, NBFC or a ‘person’. Therefore Bitcoin issued by the software cannot be classified as pre-paid instruments since a server or software cannot be termed as a ‘person’.<sup>120</sup>

The software further cannot be regulated within the minimum capital adequacy requirements set for issuers of pre-paid instruments as issuers require a capital of Rs.100 lakh and specific sanction from the RBI.<sup>121</sup> Additionally, only banks which have been permitted to provide Mobile Banking Transactions by RBI are permitted to launch mobile based pre-paid payment instruments (m-wallet and m-accounts).<sup>122</sup>

Thereby rendering Bitcoin issued by a mobileapp outside the purview of regulation of pre-paid instruments as these Bitcoin are not circulated by a bank that has prior approval of the RBI. In conclusion, Bitcoin do not fall within the recognized definition of pre-paid instruments.

### **KYC Norms – Applicability to Bitcoin**

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.<sup>129</sup> As already discussed above, the system of Bitcoin uses the block chain technology which allows the system to keep a proper track of the transactions being made. Due to its lack of physical presence, bringing Bitcoin under the current Indian laws can be difficult. The KYC requirements are also being followed by some Bitcoin exchanges before allowing customers to open accounts with them.<sup>130</sup>

### **Section 3 of the Prevention of Money Laundering Act,**

Provided upon request only are not able to identify the person, making the investigation involving money laundering much more difficult. Financial Institutions, banks and intermediaries are mandated to collect information of the clients.<sup>131</sup> However, it would appear that certain aspects of transactions in Bitcoin cannot be adequately regulated under the existing legal and regulatory framework.

### **Cross border transfer of Bitcoin**

FEMA regulates all inbound and outbound foreign exchange related transactions, in effect regulating (or managing) the capital flows coming into and moving out of the country. Section 3 of FEMA states that other than as provided (and specifically enunciated) in either FEMA (or its underlying rules and regulations) or unless special or general permission of RBI has been obtained, no person shall: 'deal in or transfer any foreign exchange or foreign security to any person not being an authorized person ;<sup>134</sup>

- 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.'

### **Taxation of Bitcoin**

For the purpose of taxation, three possible 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 tax payer), and,
- iii. transfer of Bitcoin as consideration (where Bitcoin are either a capital asset or a stock-in-trade

- iv. depending on the activity undertaken by the tax payer).

Gains on transfer of Bitcoin as capital assets are taxed under the following two heads:

- i. Long-term capital gain: When the property is held for more than 36 months, the gains are taxed as long term capital gains.
- ii. Short-term capital gains: Cases in which the capital asset is held for less than 36 months the gains will be taxed as short-term capital gains.

The question of how far adherent users of the Bitcoin currency will derive satisfaction in Bitcoin currency is shrouded with speculations. However, certain factors and recent incidents inform current and potential users of what could unfold in the Bitcoin regime.

## **6. Problems with Bitcoins**

### **I. Cyber Attacks and Hacking:**

“Virtual Bank Robbery”

Attacks by “cyber thieves” are becoming frequent with the passing of time. Especially the Bitcoin community has been hit by such thefts quite repeatedly. This not only creates panic in the Bitcoin community but also leads to a decline in the value of the currency. Cyber security will be a constant concern, mostly because the transactions are restricted only to the cyber environment.

### **II. Price Fluctuation and Inflation**

One of the major reasons why today many businesses and merchants avoid using Bitcoin is that it is new and the volatility of Bitcoin value is extremely high.<sup>168</sup> This again leads to the uncertainty and reduced confidence in the currency. Although, some think that in spite of these flaws, one of the most valuable consolations might be that there can be no artificial inflation or deflation of the currency.

### **III. Fraud**

Some say that Bitcoin will keep appealing to charlatans coming up with destructive schemes as explained above since Bitcoin offers benefits of privacy as well as limited oversight by the regulators. When compared with the traditional fiat currency that not only has extensive regulatory oversight but also offers very less privacy, Bitcoin does seem like the better option for the fraudsters.

### **IV. Uncertainties in the Government Policies**

Since most jurisdictions have not made a decision regarding the status and treatment of Bitcoin in the economy, as already discussed above, the uncertainty is a deal breaker for many new prospective users of Bitcoin. One of the major dangers here is that any government might come around and declare it illegal, leaving the investors without remedy and helpless.

## **7. Risks Related to Bitcoin**

### **Vulnerabilities in Bitcoin Transactions**

This arena of virtual transitions is relatively novel and largely untested. This means that, just like

any new technology or innovation there is a high possibility that many loopholes might exist in this system that have not been detected yet. This only adds to the appeal of the Bitcoin for financial criminals. Most prominent of these offences which are already existent in the traditional financial world and which may extend to Bitcoin are money laundering and terrorist financing.

### I. Money Laundering

One of the major enabling factors for money laundering is lack of uniform financial jurisdiction across the globe. This is the reason why certain areas are labelled as “tax havens”. It may be noted that money laundering contributes largely to the deteriorating state of economies in the world.

### II. Drug Trafficking

Silk Road, launched in June 2011, and only reachable by people using Tor, the software that lets one surf the dark web anonymously. Silk Road was used by countless people to get access to illegal merchandise, spanning from drugs to assassins for hire. An estimate of \$1.9 million dollars’ worth of Bitcoin transactions per month were done according to a research.<sup>173</sup> This came as a confirmation of the fact that Bitcoin is fast becoming the first choice for drug dealers to shelter themselves from the scrutiny of the law.

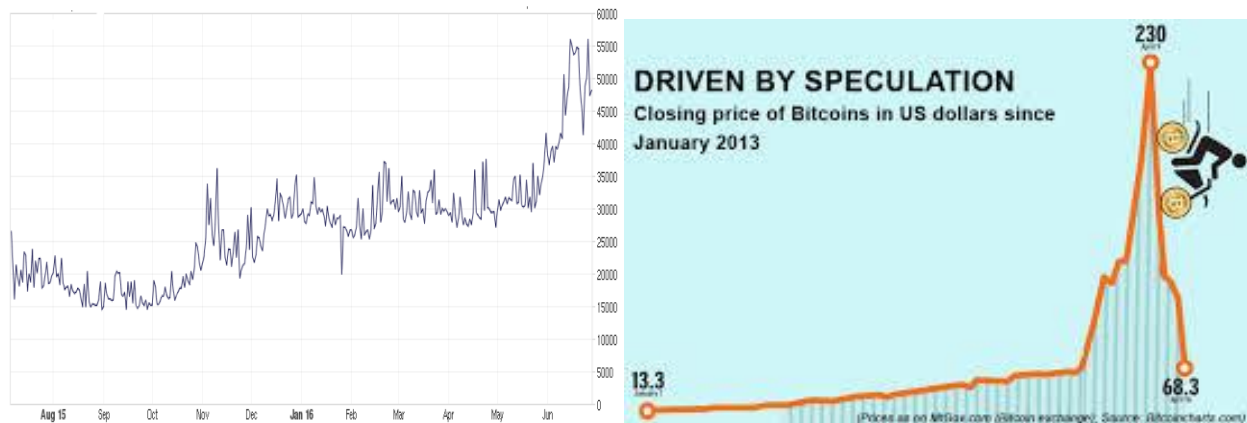
### III. Tax Avoidance and Evasion

There are very few nations who have released rules or guidelines regarding the treatment of Bitcoin for the purpose of taxation. While most countries have not resolved the issue of taxation of Bitcoins and transactions in relation to Bitcoins, it is speculated that the answer might be in affirmative.<sup>174</sup>

### IV. Terrorist Financing

The concepts of terrorist financing and money laundering have been distinguished by the International Compliance Association. Terrorist Financing is concealment of future application of financial resources that may be illegal wherein such resources are obtained from a legitimate source. On the other hand Money laundering refers to a past or present benefit.<sup>176</sup> Traditionally terrorism has been defined as the use of threat or violence to achieve a political end. However, this definition is stale.

## 8. Conclusion



Like any other currency its value fluctuates.. But unlike most real life analogue its value swung widely in a short period. When the unit first came into existence.. It was worth a few US cents. Now a single bitcoin is worth about \$460.. There are presently more than 15 million units in circulation. Some economist point to the fact that because it is limited its price will increase over the long run making it less useful as a currency and more a vehicle to store value like gold. But other point to Bitcoin's volatility, security issues and other weaknesses. Some point out that like many other technological developments firstly it will face difficulties. But it will make the way for the next crypto currency. There is possibility of theft when Bitcoins are stored in digital wallets.

Bitcoin's use on the underground Silk Road website, where users could buy drugs and guns with it is a proof that it is a bad thing. Some governments including Russia and china have heavily restricted how bitcoins can be used.

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