



Legal Aspects of Bitcoins, 2014

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Nidhi Bothra

Vinod Kothari Consultants P Ltd

1012 Krishna
224 AJC Bose Road
Kolkata – 700017

Phone 033-22811276/ 22813742/
22817715

601C, Neelkanth,
98, Marine Drive,
Mumbai-400002

Phone: 022-22817427

www.vinodkothari.com

Email: nidhi@vinodkothari.com



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The more things are forbidden,
the more popular they become

Bitcoins?



Some notable voices..

- Bitcoin a bubble without intrinsic currency value – *Alan Greenspan*
- Virtual currencies may hold long-term promise, particularly if the innovations promote a faster, more secure, and more efficient payment system. -- *Ben Bernanke, Federal Reserve Chairman*
- Third era of currency in human history
- Bitcoins are ponzi schemes and it has cautioned investors that they should be aware – U.S., SEC
- Bitcoin is Evil -- Paul Krugman, Nobel Prize winning Economist
- ***Bitcoin, have captured the imagination of some, struck fear among others, and confused the heck out of many of us.*** -- Tom Carper, U.S. senator



What are Bitcoins?

- An open source software introduced by pseudonymous developer *Satoshi Nakamoto* in 2009.
- Peer-to-peer, decentralized, private digital payment system
 - First implementation of crypto-currency
 - A network that is not controlled by any regulator/ govt./ anybody
 - It is mathematical currency



Features of Bitcoins

- Total amount of bitcoins are predictable and limited
 - electronic form of currency not backed by any real estate, coins or precious metal
 - the supply of Bitcoins is based on an algorithm
- There is no central authority/ bank acting as a intermediary
- An open source and the code can be reviewed by anyone
- The price of Bitcoin relative to other currencies is determined by supply and demand
- Lost or stolen bitcoins are gone forever
 - Users can hold bitcoins or convert to cash



How does it work?

- Relies on the principles of cryptography
- Each Bitcoin and each user is encrypted with a unique identity
 - A public and private key
- Each transaction is coded on a decentralized public ledger (*blockchain*) that is visible to all computers on the network, but does not reveal any personal information about the involved parties.
 - Blockchain records every transaction ever processed (including the bitcoins seized by SEC, U.S.)
 - Allows users to verify validity of the transaction
- The public ledger verifies that the buyer has the amount of bitcoin being spent and has transferred that amount to the account of the seller.
- The transactions are irreversible



How to obtain Bitcoins?

- Mining
 - Reward for processing transactions/ securing networks
 - Bitcoins are created at a decreasing rate
- In exchange of sale of goods or services
- Purchase at the exchange



Motivations and Deterrents

- Motivations
 - Used as an effective medium of exchange
 - Lower transactions costs
 - Increased privacy in dealings (also a growing concern)
 - Works on lines of Jane Jacob's theory of local currency, which acts as a medium of exchange and allows depressed regions to pull itself. Local currency is not backed by national government and restricted to smaller areas
- Deterrents
 - There is high volatility in the prices of bitcoins
 - Often quoted as an bubble
 - Similarities drawn with the Dutch Tulip Mania
 - Uncertain security from theft, frauds, money laundering
 - The Silk Road, online black market was shut down by the U.S. FBI and 1,44,000 bitcoins were seized worth US\$28.5 million
 - Long term deflationary bias, encouraging hoarding of bitcoins
 - It is not a legal tender at the end of the day, don't have intrinsic value
 - Glitches of traffic load



Countries' Perspective on Bitcoins

- Argentina has banned foreign currency
- Thailand has expressed reservations on licensing Bitcoin exchanges
- France and Russia declared bitcoins illegal
- Recently, China has restricted bitcoin exchange for local currency and prohibited financial institutions from using bitcoins. (Buying real-world goods with any virtual currency has been illegal in China)
 - The Central Bank released statement similar to RBI, saying that while computer generated currency did not pose threat to the Chinese financial system it posed several risks
- In Germany, bitcoins have been classified as private money or units of account
- Europe has expressed reservations that bitcoins lack consumer protection



Regulatory perspective globally

- Financial Crimes Enforcement Network's (FinCEN) issued Guidance to clarify
 - applicability of the regulations implementing the Bank Secrecy Act to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies
 - an administrator or exchanger is an Money Servicing Business under FinCEN's regulations
 - MSB definition was amended to include persons engaged in virtual currency transactions
- The Guidance states
 - *A person that creates units of this convertible virtual currency and uses it to purchase real or virtual goods and services is a user of the convertible virtual currency and not subject to regulation as a money transmitter. By contrast, a person that creates units of convertible virtual currency and sells those units to another person for real currency or its equivalent is engaged in transmission to another location and is a money transmitter. In addition, a person is an exchanger and a money transmitter if the person accepts such de-centralized convertible virtual currency from one person and transmits it to another person as part of the acceptance and transfer of currency, funds, or other value that substitutes for currency*



Regulatory perspective globally

- EU Directive suggesting that bitcoin could fall under the Electronic Money Directive of the Union. The Directive uses three criteria to define electronic money
 - Stored electronically
 - Accepted as a means of payment by undertakings other than the issuer
 - issued on receipt of funds of an amount not less in value than the monetary value issued



Views from the judiciary

- In the matter of Securities and Exchange Commission vs. Trendon T Shavers and Bitcoin Savings and Trust, the U.S District Court, Texas released a Memorandum Opinion, relevant extract is below
 - *It is clear that Bitcoin can be used as money. It can be used to purchase goods or services, and as Shavers stated, used to pay for individual living expenses. The only limitation of Bitcoin is that it is limited to those places that accept it as currency. However, it can also be exchanged for conventional currencies, such as the U.S. dollar, Euro, Yen, and Yuan. Therefore, Bitcoin is a currency or form of money, and investors wishing to invest in BTCST provided an investment of money.*



RBI on Bitcoins

- India ranks amongst the top 30 Bitcoin using countries – WSJ Report
 - Currently in possession of 1% of the 21 million bitcoins in global circulation
- Indian Bitcoin software downloads in the recent times has been double the average rate of growth in Bitcoin downloads registered by the other thirty countries
- RBI in a press release dated 24th December, 2013 cautioned users/ holders/ traders of virtual currencies against risks
 - RBI cautioned that it has not authorised virtual currencies including bitcoins as a medium of payment
 - No regulatory authorisations/ approvals have been taken by entities undertaking such activities.
 - There are apprehensions of users unintentionally breaching the anti-money laundering laws
 - Virtual currencies pose potential financial, operational, legal, customer protection and security related risks



Legal analysis of bitcoins – what is it?

- Potential legal expression for bitcoins
 - Goods
 - Implication – VAT on sale of goods applies; show will come to immediate stop
 - Money
 - Financial laws such as Money Circulation Schemes banning law may apply
 - Currency
 - “Bank note” under the RBI Act
 - Legal prohibition
 - Actionable claim
 - Transfer of Property Act may apply; may require conveyance
 - Security
 - Securities Contracts Regulation Act will apply; SEBI to regulate transactions
 - Negotiable instrument



Are Bitcoins securities?

- Black's Law Dictionary defines security as --
 - an instrument that represents a claim on something else or is an obligation of one entity to pay another entity
- *An Evidence of a corporation's debts or assets*
- Sec. 2 of Securities Contract Regulation Act 1956 defines securities to include
 - shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate; (ii) Government securities; (iii) rights or interests in securities (iv) derivatives, (v) units of CIS, mutual funds, SRs.
- Bitcoin is not a claim on any asset
 - Not an instrument, not backed by anything, it is voluntary in nature
 - Does not obligate one party to pay to another party
 - Hence not capable of creating financial liability



Are Bitcoins actionable claim/ negotiable instruments?

- Actionable claims, as defined under Transfer of Property Act, mean *“a claim to any debt...”*
 - A claim to debt, receivables
- A negotiable instrument has been defined in Negotiable Instruments Act, 1881 as
 - promissory note, bill of exchange or cheque payable either to order or to bearer
- Bitcoins do not fall under any of the three above



Are Bitcoins Goods?

- Article 366(12) of the Constitution of India defines - “goods includes all materials, commodities, and articles”
- Sale of Goods Act, 1930: “Goods” means every kind of movable *property* other than actionable claims and money; and includes stocks 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 [Section 2 clause (7)].
 - Goods are capable of abstraction, consumption, use, abuse, transmitted, transferred, delivered, stored possessed, etc
- In Chapter-13, "The Law of Property", in Salmond's Jurisprudence, property is defined to include
 - Material things and immaterial things
 - Rights *in rem*



Are Bitcoins Goods?

- Black's Law dictionary defines property as
 - That which is peculiar or proper to any person; that which belongs exclusively to one. In the strict legal sense, an aggregate of rights which are guaranteed and protected by the government.
- In *Fulton Light, Heat & Power Co. v. State* 65 Misc. Rep. 263, 121 N.Y.S. 536.
 - The term property is said to extend to every species of valuable right and interest. More specifically, ownership; the unrestricted and exclusive right to a thing; the right to dispose of a thing in every legal way, to possess it, to use it, and to exclude every one else from interfering with it. That dominion or indefinite right of use or disposition which one may lawfully exercise over particular things or subjects. The exclusive right of possessing, enjoying, and disposing of a thing. The highest right of man can have to anything; being used to refer to that right which one has to lands or tenements, goods or chattels, which no way depends on another man's courtesy.



Are Bitcoins Goods?

- While Bitcoins can fall under the inclusive definition of goods but there are elements missing
 - Bitcoins are fungible so don't have exclusive right on the thing
- In case of Sunrise Associates vs. Govt of India
 - While discussing a lottery ticket, which in entitlement to the contingent prize, it was held that the lottery ticket by itself was not a good, but a contingent claim.
 - In case of bitcoins
 - Is it a right or entitlement? Some one's right is someone's obligation
 - It is a representation of value
 - Is it property? Does it have a value by itself? It is only a means to settle transactions, then it must be "money"
- Further, money has been specifically excluded from the definition of goods.
 - Money is a medium of exchange and serves as a common standard of value by reference to which the comparative values of different commodities are ascertained
- If we were to assume that Bitcoins are goods that does not cease it to be money and hence the exclusion from definition of goods. (Reliance on Imperial Tobacco Co. v. IRC 25 TC 292 (CA))



Are Bitcoins Money?

- Black's Law dictionary defines money as
 - A general, indefinite term for the measure and representative of value; currency; the circulating medium ; cash. "Money" is a generic term, and embraces every description of coin or bank-notes recognized by common consent as a representative of value in effecting exchanges of property or payment of debts.
- Webster's Encyclopedic Unabridged Dictionary
 - Any article or substance used as medium of exchange, measure of wealth or means of payment;
- Money has four functions
 - Medium of exchange
 - Standard of payment
 - A unit of account
 - Store of value
- Bitcoins are a representation of value
 - They do not have value of their own, they derive value from the demand and supply of bitcoins in the market and the willingness of the entities to hold/ possess/ trade in them
- Commentary of Pollock & Mulla (6th Edition) on "Sale of Goods Act"
 - Money is necessarily excluded from the definition, not only because it constitutes the price in exchange for which the goods are sold, but because it is governed by wholly different principles of law, owing to its being currency. It is not, therefore, regarded as a chattel, but as something '*sui generis*'



Are Bitcoins currency?

- Bitcoins have value because they are useful form of money
- Bitcoin has characteristics of money
 - durability, portability, fungibility, scarcity, divisibility, and recognizability
 - Based on mathematical properties rather than relying on physical properties or trust in central authorities
- A country's currency is backed by that country's government.
 - This backing can either be by fiat (government regulation or law) or by commodity (such as the gold standard).
- While Bitcoins may not currently classify as currency, but they surely do fulfill the essentialities of money



Are Bitcoins currency? (Cont..)

- FinCEN's regulations define
 - currency (referred to as “real” currency) as “the coin and paper money of the United States or of any other country that
 - is designated as legal tender and that
 - circulates and
 - is customarily used and accepted as a medium of exchange in the country of issuance
 - Virtual currency
 - a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency. In particular, virtual currency does not have legal tender status in any jurisdiction.



To Sum it up..

- Bitcoins have a dual character of currency and payment network
 - Bitcoins have surely emerged as a useful payment system
- Bitcoins are themselves not illegal, they are put to illegal use
- Bitcoin is nothing but a computer code, security is a risk
- Risk of illegal transactions flourishing because they are outside the global regulators radar
- Regulators may want to tax these transactions/ qualify then as payment service
- The volatility in bitcoin prices has been a concern whether it would be good investment
 - Law of supply and demand do not guarantee value of bitcoins in future. As in case of currencies, if confidence in bitcoins is lost, it will no longer have value.



Way forward

- In India it is not easy to convert rupee to other currencies
 - Capital account transactions are not freely convertible
- In the U.S more active of the rest of the markets, bitcoin exchanges are regulated as money service businesses and are are obligated to report any activity symptomatic of money laundering
 - A US Justice Department official said at a US Senate committee hearing that Bitcoins could be “*legal means of exchange*”
- Australia, Canada, Finland, and Germany have simply made it clear that normal earned income rules apply to Bitcoin
- Other states reject the label of currency but will collect taxes on Bitcoin transactions, such as Norway
- Bitcoins are not replacement of a currency it has a complimentary function to the currency



Way forward

- Definition of currency has scope for expansion, Sec. 2 (h) of FEMA, 1999 defines 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
- If legalized Bitcoins will have to comply with the FEMA regulations
- In India it is not easy to convert rupee to other currencies
- Cyber security will be a huge challenge
- If the bitcoins were traded/ exchanged within India, there should not be an issue



Way forward

- If we were to take the assumption that bitcoins were goods and not currency
 - Section 4 of the Sale of Goods Act says that the consideration for sale has to be money
 - Since bitcoins are goods, exchange of goods for goods would become a barter exchange and hence ruled out from being a transaction of sale of goods.
 - If it is not considered to be a barter and a sale of goods, applicability of VAT will be an issue and might kill the market