

Research Article

Crypto Regulation in India: From Legal Uncertainty to Hybrid Governance

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Abstract

Cryptocurrency regulation in India has developed through a combination of judicial decisions, tax legislation, anti-money laundering requirements, administrative measures and policy statements rather than through one comprehensive statute. For several years, the central legal question was whether cryptocurrencies were prohibited, permitted or merely tolerated. This binary approach is no longer sufficient to explain India's present legal position. India has gradually developed a hybrid regulatory model in which crypto assets are recognised for certain legal purposes, particularly taxation and anti-money laundering compliance, but are not treated as legal tender or fully integrated into the regulated financial system.

This article examines the major strands of Indian literature and legal policy concerning crypto regulation. It analyses the conceptual nature of blockchain-based assets, monetary sovereignty concerns, the taxation of virtual digital assets, obligations under the Prevention of Money Laundering Act, constitutional questions arising from the Reserve Bank of India's 2018 circular, and the significance of the Supreme Court's decision in *Internet and Mobile Association of India v. Reserve Bank of India*. The article also considers comparative regulatory approaches and evaluates the consequences of India's fragmented framework.

The article argues that the Indian regulatory approach should be understood as a system of managed ambiguity or hybrid governance. India has not imposed an absolute prohibition on crypto assets, but it has also not created a comprehensive licensing, consumer-protection and market-conduct framework. The present system combines recognition, taxation, surveillance and institutional caution. A future regulatory framework should integrate taxation, AML/CFT obligations, investor protection, financial stability, constitutional proportionality and technological innovation within a coherent statutory structure.

Keywords: Cryptocurrency Regulation, Financial Law, Tax Law, Anti-Money Laundering Law and Constitutional Law.

1. INTRODUCTION

Cryptocurrency is one of the most significant developments in contemporary financial technology. Unlike traditional currencies issued and controlled by a central bank, cryptocurrencies generally operate through decentralised networks based on blockchain technology. Blockchain enables transactions to be recorded on a distributed ledger, reducing dependence on a central intermediary. This technological structure has created new forms of digital value, investment and payment, but it has also raised complex legal and regulatory questions.

In India, the development of cryptocurrency has been accompanied by uncertainty. Public authorities have expressed concerns regarding monetary sovereignty, consumer protection, financial

stability, tax evasion, cybercrime and money laundering. At the same time, crypto exchanges, investors, technology companies and blockchain developers have argued that excessive restrictions may discourage innovation and drive businesses outside India.

The Reserve Bank of India initially adopted a restrictive position. In 2018, the RBI directed regulated entities not to provide banking services to individuals or businesses dealing with virtual currencies. This circular had a serious effect on cryptocurrency exchanges because access to banking channels is essential for deposits, withdrawals, payments and business operations. The circular was challenged before the Supreme Court in *Internet and Mobile Association of India v. Reserve Bank of India*.

The Supreme Court set aside the circular on the ground of proportionality. The judgment did not declare cryptocurrency to be legal tender, nor did it prevent Parliament from regulating or prohibiting crypto assets through valid legislation. However, it established that regulatory measures affecting the freedom of trade must be supported by relevant evidence and must not be excessive in relation to the objective pursued.

Since the judgment, India has introduced important tax and anti-money laundering measures. The Income-tax Act now provides a specific regime for virtual digital assets. Income from the transfer of a VDA is subject to a flat tax rate of 30%, and section 194S imposes tax deduction at source obligations in specified cases. Crypto-related service providers have also been brought within the anti-money laundering framework as reporting entities.

This article examines these developments and argues that India's current framework is neither a complete prohibition nor full legal recognition. It is a layered system that combines taxation, compliance and regulatory caution. The article therefore describes India's approach as a hybrid governance model.

2. Objectives of the study

1. To know the crypto regulations in india
2. To find out the mechanism for cryptocurrencies in india.
3. to propose investor protection system.

3. Hypothesis

There is no proper mechanism to regulate the crypto currency in india.

4. Methodology

There are doctrinal, comparative, and empirical methodologies to evaluate the research problem from theoretical, global, and practical dimensions. The doctrinal component establishes the analytical foundation by synthesizing legal sources and commentaries, while the comparative analysis evaluates functional equivalents across selected jurisdictions to identify institutional best practices and models for reform. To bridge the gap between statutory intent and real-world execution, By triangulating qualitative legal analysis with empirical data, this mixed-method framework enhances the validity of the findings to offer a comprehensive assessment of both legal theory and its practical societal impact.

2. CONCEPTUAL AND LEGAL NATURE OF CRYPTOCURRENCY

2.1 Meaning of cryptocurrency

Cryptocurrency is a form of digitally recorded value that uses cryptographic techniques to secure transactions and control the creation or transfer of units. Bitcoin, Ether and other tokens are commonly described as cryptocurrencies, although they may perform different economic functions. Some are used primarily as investment assets, some are used within blockchain ecosystems, and others are designed to facilitate payments or access to particular services.

The legal classification of cryptocurrency is difficult because it does not fit comfortably within traditional categories. It may possess some characteristics of money, property, commodity, security or financial product. The classification adopted by a legal system determines the applicable regulatory consequences.

2.2 Blockchain technology

Blockchain is a distributed ledger technology that records transactions across a network of computers. Each transaction is verified through a consensus mechanism and added to a chain of

blocks. The system is designed to make unauthorised alteration difficult and to provide a transparent record of transactions.

Blockchain has applications beyond cryptocurrency. It may be used in supply chains, land records, digital identity, healthcare, intellectual property and public administration. Therefore, legal regulation must distinguish between blockchain technology generally and crypto assets specifically.

2.3 Virtual digital assets under Indian law

Indian tax law uses the expression “virtual digital asset.” The statutory definition includes information, code, number or token generated through cryptographic means or otherwise that represents digital value and can be transferred, stored or traded electronically. It also includes non-fungible tokens and other notified digital assets.

The use of the term VDA is important because it provides a legal category for taxation. However, tax recognition does not automatically mean that crypto assets are recognised as currency, securities or legal tender. The VDA category is primarily a tax and compliance category.

3. EVOLUTION OF CRYPTO REGULATION IN INDIA

3.1 Initial regulatory uncertainty

During the early years of cryptocurrency development in India, there was no comprehensive legislation specifically governing crypto assets. Different public institutions issued warnings concerning the risks of virtual currencies. These warnings focused on volatility, fraud, money laundering, cybercrime and the absence of consumer protection.

The absence of a specific statute created uncertainty for investors and businesses. Although holding or trading crypto was not expressly prohibited by a general law, the absence of regulatory recognition made it difficult for exchanges to operate within the banking system.

3.2 The 2018 RBI circular

In April 2018, the RBI directed entities regulated by it not to deal in or provide services facilitating transactions involving virtual currencies. The circular restricted banks and other regulated entities from maintaining accounts, registering exchanges, dealing with virtual currency exchanges or facilitating settlement of such transactions.

The practical result was a banking prohibition. Crypto businesses were not directly outlawed, but their access to essential financial infrastructure was severely affected. This distinction between direct prohibition and indirect restriction became central to the constitutional challenge.

3.3 The IMAI judgment

In *Internet and Mobile Association of India v. Reserve Bank of India*, the Supreme Court set aside the RBI circular. The Court recognised the RBI’s power to regulate activities connected with virtual currencies where they affected the regulated financial system. However, the Court held that the restriction must satisfy constitutional proportionality.

The judgment is significant for three reasons. First, it confirmed that the RBI could not rely solely on general concerns without demonstrating a rational connection between the measure and the harm sought to be prevented. Second, it protected the freedom to carry on trade under Article 19(1)(g), subject to reasonable restrictions. Third, it clarified that the judgment did not prevent Parliament from enacting a valid legislative framework.

The decision did not settle the entire question of crypto legality. It only invalidated the particular banking restriction. Consequently, the legal position after the judgment remained incomplete.

4. TAXATION OF VIRTUAL DIGITAL ASSETS

4.1 Introduction of the VDA tax regime

The Finance Act, 2022 introduced a special tax regime for income arising from the transfer of virtual digital assets. Section 115BBH provides that income from the transfer of a VDA is taxable at the rate of 30%, subject to applicable surcharge and cess.

The provision permits deduction only for the cost of acquisition. Other expenditure or allowances cannot generally be deducted, and losses arising from the transfer of one VDA cannot be set off against income from another VDA or other sources.

4.2 Tax deduction at source

Section 194S introduced a TDS requirement in respect of consideration paid for the transfer of a VDA. In specified cases, 1% TDS applies when payment is made to a resident for transfer of a VDA.

The TDS provision serves multiple purposes. It creates a reporting trail, assists the tax department in identifying transactions and discourages concealment of crypto income. However, it may also increase compliance costs, particularly for peer-to-peer transactions and decentralised platforms.

4.3 Tax recognition and legal status

The VDA tax regime raises an important interpretive issue. If the State taxes crypto income, does that mean cryptocurrency is legally recognised? The answer requires distinction between taxation and legal tender. Taxation acknowledges the existence of an economic activity, but it does not necessarily approve the asset as money or provide it with the status of sovereign currency.

India's approach therefore reflects regulatory pragmatism. Instead of waiting for a complete crypto statute, the State has created a mechanism to tax gains and monitor transactions. The tax regime represents recognition for fiscal purposes without full financial-sector acceptance.

4.4 Effect of the tax regime

The high tax rate and restrictions on loss adjustment may discourage frequent trading and speculative activity. The regime also signals that the government does not intend to promote crypto as an alternative monetary system. At the same time, taxation provides certainty to taxpayers by establishing rules for reporting and computation.

The major criticism is that the regime may be insufficiently sensitive to the different types of digital assets and business models. A long-term investor, a trader, a miner, a validator, a decentralised finance user and an exchange may face different economic realities. A uniform tax approach may therefore create unfair or inefficient results.

5. ANTI-MONEY LAUNDERING AND AML/CFT COMPLIANCE

5.1 Crypto assets and illicit finance

Crypto assets have raised concerns because transactions can occur across borders and may involve pseudonymous wallet addresses. Although blockchain transactions are often publicly visible, identifying the persons behind the addresses may be difficult. Criminals may attempt to use mixers, privacy-enhancing tools, offshore exchanges or peer-to-peer networks to conceal the origin of funds. These risks have brought crypto regulation within the international AML/CFT framework. The Financial Action Task Force has emphasised the importance of regulating virtual asset service providers and requiring customer due diligence, record-keeping and suspicious transaction reporting.

5.2 Application of the PMLA framework

India brought virtual digital asset service providers within the Prevention of Money Laundering Act framework as reporting entities. The obligations generally include registration with the Financial Intelligence Unit-India, customer identification, beneficial ownership checks, transaction monitoring, maintenance of records and reporting of suspicious transactions.

The AML framework represents a major shift in Indian policy. It treats exchanges and related intermediaries as participants in the financial system even though crypto itself is not treated as legal tender. This is another example of hybrid governance.

5.3 Compliance obligations

Crypto service providers may be expected to undertake the following functions:

- Conduct customer due diligence.
- Verify customer identity and beneficial ownership.
- Maintain transaction and customer records.
- Monitor unusual or suspicious activity.
- File suspicious transaction reports.
- Comply with applicable reporting requirements.
- Establish internal controls and compliance systems.

These obligations may improve market integrity, but they also impose significant costs. Smaller platforms may find it difficult to maintain adequate compliance departments, transaction-monitoring systems and cybersecurity infrastructure.

5.4 FATF-oriented regulation

FATF standards encourage a risk-based approach. This means that compliance should be proportionate to the nature, size and risk profile of the business. A major exchange handling large cross-border transactions should not necessarily be treated in exactly the same way as a small blockchain software provider.

India's future regulatory policy should distinguish between custodial exchanges, wallet providers, decentralised protocols, token issuers, mining operations and technology developers. Overbroad compliance requirements may discourage innovation without necessarily reducing illicit finance.

6. CONSTITUTIONAL AND ADMINISTRATIVE LAW ISSUES

6.1 Article 19(1)(g) and freedom of trade

The right to practise any profession or carry on any occupation, trade or business under Article 19(1)(g) is not absolute. The State may impose reasonable restrictions in the interests of the general public. However, a restriction must have a rational connection with the objective and must not be excessive.

The IMAI judgment demonstrated the relevance of proportionality in economic regulation. Even when a regulator is acting to protect financial stability, the measure must be based on evidence and must be appropriately tailored.

6.2 Proportionality

Proportionality generally requires consideration of whether:

- The measure has a legitimate objective.
- The measure is suitable to achieve that objective.
- A less restrictive alternative was available.
- The burden imposed is excessive in relation to the public benefit.

The Supreme Court's reasoning indicates that the existence of regulatory power does not eliminate the need for constitutional review. This principle will remain important if India introduces more restrictive crypto legislation.

6.3 Separation of functions

India's crypto framework involves several institutions, including the RBI, the Ministry of Finance, the Income Tax Department, the Financial Intelligence Unit and other enforcement agencies. Institutional involvement is understandable, but overlapping authority can cause uncertainty.

A comprehensive law should identify the responsibilities of each regulator. It should also provide mechanisms for information sharing, licensing, appeals, investigation and judicial review.

6.4 Administrative fairness

Crypto businesses require clarity regarding registration, compliance, inspection, enforcement and penalties. Regulatory decisions should be supported by clear standards and should follow principles of natural justice. Arbitrary blocking of accounts or platforms without notice and review may raise constitutional and administrative law concerns.

7. CONCLUSION

Crypto regulation in India has evolved from regulatory uncertainty to a system of partial recognition and layered control. The State has not adopted an absolute prohibition, but it has also not fully integrated cryptocurrencies into the formal financial system. Instead, India has relied on taxation, AML obligations, judicial review and institutional caution.

The Supreme Court's decision in *Internet and Mobile Association of India v. Reserve Bank of India* established that regulatory restrictions must satisfy constitutional proportionality. The VDA tax regime created a fiscal framework, while AML measures brought crypto service providers within the financial-integrity system. These developments demonstrate that crypto assets are now part of India's legal and economic landscape.

However, the present framework remains fragmented. It does not fully address licensing, consumer protection, market manipulation, custody, stablecoins, decentralised finance, token

classification or dispute resolution. The absence of a comprehensive law continues to create uncertainty for businesses, investors and regulators.

India's present approach is therefore best understood as hybrid governance. Crypto is acknowledged for taxation and compliance purposes, restricted in relation to monetary sovereignty and subject to continuing regulatory caution. The central legal challenge is to convert this fragmented framework into a coherent system that balances innovation, financial stability, consumer protection, constitutional rights and national security.

A future regulatory framework should not be based solely on the question of whether cryptocurrency is legal or illegal. It should instead ask what type of digital asset is involved, what risks it creates, which institution should regulate it and what safeguards are necessary. Such an approach would allow India to move from managed ambiguity toward principled and predictable regulation.

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