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The CRA takes the currency out of cryptocurrency

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In recent years, digital currencies called “cryptocurrencies” have exploded in mainstream popularity. Cryptocurrencies, such as Bitcoin, Ethereum and Litecoin were once accepted by only a few online vendors, but now may be used as payment at some restaurants, retail stores and even real estate brokers.

What is a cryptocurrency?

A cryptocurrency is a form of digital currency that is decentralized and managed by a peer-to-peer network. Rather than one central organization providing oversight and control of the currency – like a central bank would for its country’s legal tender – the control lies with a network of users who confirm every transaction. Once transactions are confirmed by the network, they are posted to a digital ledger called the “blockchain,” which is an immutable, publicly-accessible record of all transactions that have taken place. Thanks to the global popularity of cryptocurrencies, this confirmation normally occurs within minutes.

The activity of confirming cryptocurrency transactions and adding them to the blockchain is called “mining.” Miners are incentivised to perform these confirmations because they are rewarded with units of the cryptocurrency they mine. (A later Tax Alert will address the complicated area of mining in more detail.) Many investors believe that, since Bitcoin and other cryptocurrencies are not centralized, there are no tax implications to buying, selling or trading them.

The CRA’s position

In Canada, the Currency Act defines “legal tender” as coins issued by the Royal Canadian Mint or notes issued by the Bank of Canada. Thus, cryptocurrencies are not considered a form of Canadian currency, but they do not qualify as foreign currency either. The Canadian Income Tax Act defines foreign currency as the currency of any country other than Canada. Since cryptocurrencies are decentralized and therefore not controlled by another country or central bank, they are not considered a currency of any other country.

As a result of these two interpretations, the CRA has determined that cryptocurrencies are a commodity, not a currency. The tax treatments of various transactions using cryptocurrencies are described below.

Buying and selling

The CRA considers the buying and selling of cryptocurrencies to be similar to the buying and selling of regular securities – such as mutual funds or corporate equities – by an investor. Just as an investor must pay tax on a capital gain when they sell a share of a company held in their portfolio, an investor in Bitcoin must pay tax on a capital gain when they convert their Bitcoins into another currency (e.g. the Canadian dollar). The gain is calculated based on the market value of the Bitcoins when they are exchanged for currency, less the amount originally paid for the Bitcoins.

In some cases, the selling of cryptocurrencies is considered to be on account of income, rather than capital. IT-479R “Transactions in Securities” lists the following factors, which are considered by the courts when determining whether a disposition of a security is on account of income or capital:

- 1. Frequency of transactions** – Is the investor trading a few times a year or a few times a day?
- 2. Period of ownership** – Is the investor holding the cryptocurrency for a few years or a few weeks?
- 3. Knowledge of securities markets** – Is the investor knowledgeable and familiar with the cryptocurrency (or other securities) market or are they just dabbling?

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- 4. Time spent** – Does the investor spend hours a day on trading and keeping up to date with the market or just a few hours a month?

If the transaction is considered to be on account of income, the taxpayer must record the proceeds of disposition of the cryptocurrency as business income and may therefore deduct any eligible expenses against that income. If the transaction is on account of capital, the taxpayer must report a capital gain or loss, as applicable.

Exchanging for goods and services

Where a unit of cryptocurrency is exchanged for a good or a service, the CRA considers the exchange to be a barter transaction. IT-490 “Barter Transactions” defines a barter transaction as a transaction between two persons in which one commodity is exchanged for another without the use of money.

From the vendor’s perspective, they have sold a good or a service and must include the value of the good or the service in their income for the year, just as if they had provided that particular good or service in the normal course of business. The GST/HST will apply on these transactions and will be calculated based on the fair value of the transaction, which is the fair value of the good or the service given up by the vendor. Consider, for example, a restaurant providing a meal in exchange for a Bitcoin. If the meal normally costs \$20, the restaurant would recognize income of \$20. The GST/HST is calculated on the value of consideration: the Bitcoin. Thus, a GST/HST liability would be calculated by multiplying the restaurant’s applicable rate by the value of that one Bitcoin.

From the purchaser’s perspective, they have disposed of a commodity and must pay tax on the disposition in the form of a capital gain. In the same restaurant example, the consumer who consumed the meal that would normally cost \$20 must report a disposition of property. The taxable capital gain would be the \$20, less the amount paid for the Bitcoin originally.

For ease of explanation, this example assumes that a Bitcoin would be equal in value to the amount paid for the meal. In reality, a single Bitcoin currently is worth thousands of dollars, so there would obviously be a fractional unit exchanged for the meal.

Donations

If a taxpayer makes a donation of cryptocurrency units to a registered charity, the transaction will be treated as an in-kind gift of capital property, which is discussed in IT-288R2 “Gifts of Capital Properties to a Charity and Others.” There will be a disposition equal to the fair value of the cryptocurrency donated. However, the taxpayer may elect for the proceeds of disposition to be anywhere between the fair value and the adjusted cost base. This election could allow for no capital gain to be realized on the donation.

Keeping records

Due to the inherent anonymity of cryptocurrencies and the blockchain, the CRA has an expectation that taxpayers engaged in transactions using cryptocurrencies should go above and beyond standard record-keeping practices. The most prudent approach is to document and retain everything relating to cryptocurrency transactions. This could be an especially tedious process for someone who uses Bitcoins for day-to-day transactions, as in the restaurant example above.

Since cryptocurrencies are relatively new, there remains some uncertainty regarding the tax implications of transactions. When in doubt, consult with your Collins Barrow advisor to ensure that your cryptocurrency affairs are in order before the CRA comes knocking at your door.

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