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TAX NOTE

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Taxation of Cryptocurrency

The proliferation of Bitcoin and other cryptocurrency investments has led to a multitude of tax-related questions. Clients frequently ask how gains or losses on cryptocurrency should be reported, what audit tools the Canada Revenue Agency ("**CRA**") is using to detect cryptocurrency transactions and whether there are any remedies for taxpayers who have inadvertently failed to comply with their obligations under the *Income Tax Act* (the "**Act**").

General Principles

Cryptocurrency are novel digital assets that are not governed by any central authority or government. Once acquired, records of ownership are preserved only in blockchain records, which are decentralized ledgers stored across many computers. It is this dissemination of storage responsibility that preserves the integrity of the cryptocurrency asset. There exist literally hundreds of cryptocurrencies with different peculiarities, the most common being Bitcoin.

The income tax treatment of cryptocurrency, unsurprisingly, is not addressed explicitly in the Act. The CRA has issued administrative positions indicating that it will treat cryptocurrency as a commodity. This means that disposing of units of cryptocurrency can give rise to either business income or capital gains and losses, depending on the circumstances. The use of cryptocurrency to pay for goods or services is treated as a barter transaction where the fair market value of the cryptocurrency tendered, in Canadian dollars, is used as the basis for determining the tendering taxpayer's income inclusion or proceeds of disposition. The CRA's view is that the fair market value must be determined having regard to a reasonable method applied on a consistent basis and records should be kept with respect to how that value was determined.

Taxpayers may apply general principles of commodity trading to ascertain whether cryptocurrency profits constitute business income or capital gains. A trader with frequent cryptocurrency trades, that carries on their trades in a commercial manner or who does not intend to hold the cryptocurrency for a long period of time, for example, probably carries on a trading business. By contrast, an intention to buy and hold cryptocurrency coupled with lengthy ownership makes it more likely that any gains or losses on the disposal of the cryptocurrency will be capital gains or losses.

[1] See e.g. Guide for cryptocurrency users and tax professionals <https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/digital-currency/cryptocurrency-guide.html>.

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Transactions off the Radar

An appealing feature of cryptocurrency is its private and encrypted nature. This said, caution is warranted when the anonymity of cryptocurrency is relied upon to avoid detection by the CRA. As a growing number of retailers accept cryptocurrency as payment (for example, Tesla has recently begun accepting Bitcoin as payment), tax authorities' desires to detect and audit cryptocurrency transactions have intensified.

A recent order of the Federal Court on March 19, 2021, made in relation to Coinsquare Ltd. ("Coinsquare"), foreshadows future CRA audit activity. Coinsquare is a cryptocurrency exchange from which the CRA sought the production of a variety of records surrounding its customers and their cryptocurrency trades. The CRA sought the information on an "unnamed persons" basis, which required the CRA to satisfy a judge that the unnamed person or group is ascertainable and that the requirement is made to verify that the unnamed persons have complied with their tax obligations. In the Coinsquare case, the Federal Court concluded that high volume or high value traders constituted an ascertainable group and the CRA's request related to compliance with the group's tax obligations. The CRA's request for the information was granted.

This order will likely embolden the CRA in relation to other forums where cryptocurrency is acquired or exchanged for goods and services. We expect the CRA to attempt to compel vendors who accept payment in Bitcoin and other cryptocurrencies to produce identifying customer records to facilitate project audits.

Voluntary Disclosures

The world of cryptocurrency is rapidly evolving, and so it is unsurprising that many taxpayers are unsure about their reporting obligations and may have made errors because of inadvertence or otherwise. Where significant amounts of cryptocurrency are involved, this may be a daunting circumstance as those taxpayers, if audited, could face penalties, arrears interest or even more serious legal consequences.

If errors are detected by taxpayers before they are detected by the CRA, those taxpayers may be able to take advantage of the CRA's Voluntary Disclosures Program, which permits a taxpayer to come forward with respect to a failure to fulfill their tax obligations. By doing so, the disclosing taxpayer may have interest, penalties and exposure to criminal liability waived by the CRA. Certain criteria must be met in order for a taxpayer to file a valid voluntary disclosure, including a requirement that the CRA must not have already detected the error.

We're here to help

Our team has significant experience dealing with the tax considerations surrounding cryptocurrency and remedying any mistakes in reporting. If we can be of assistance to you or your clients on these issues, please do not hesitate to contact us.