



Taxation of Virtual Currencies

By Joseph Micallef, Partner and National Tax Leader, Financial Services, KPMG in Canada, and John Bain, Partner and National Leader, Indirect Tax, KPMG in Canada

A virtual currency has no physical form, and it does not provide its owner with any inherent rights to property or another currency. Traditionally, the central bank of a sovereign nation creates currency. However, no centralized authority, governmental or otherwise, controls the digital system.

Virtual currency is an emerging financial medium which may be used to pay for goods or services, or held for investment. These virtual currencies are a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like “real” currency—i.e., the coin and paper money of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance—but it does not have legal tender status in any jurisdiction.

Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as “convertible” virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies.

Canadian Lawmaker’s View on Virtual Currencies

Although in its infancy, the taxation of virtual currency possesses complex issues for both lawmakers and holders in defining how this medium is taxed and to answer the question: is it money? It should be noted that since lawmakers in most jurisdictions have not legislated nor acknowledged this as an official currency, the taxation treatment of virtual currency will likely continue to evolve. Potentially, its character for tax purposes may consequently change with such evolution.

Currently, Canadian regulatory authorities posit that digital currency does not constitute either money or currency. In 2014, the Bank of Canada released a position paper concluding that bitcoin and other virtual currencies fail to meet the definition of money.

Similarly, in 2013, an interpretation letter released by the Canada Revenue Agency (CRA) stated that bitcoin and other digital currencies were not currency for Canadian tax purposes. Instead, the CRA concluded that a bitcoin was a commodity, like gold or oil. Thus, they stated that the tax rules concerning transactions in digital currencies would be equivalent to barter arrangements.

Canadian Income Tax Treatment of Virtual Currency

The CRA is of the view that digital currencies should be treated, at least for now, as a commodity for income tax purposes. As a result, transactions in bitcoin or other digital currencies are subject to the same rules as barter transactions; transactions where one commodity is exchanged for another. This means that in a barter transaction between individuals who are dealing with each other at arm’s length, it is a fundamental principle that each of these individuals consider that the value of whatever is received



is at least equal to the value of whatever is given up in exchange. This principle serves as a basis in order to determine a digital asset's cost base as well as consideration in respect of a sale or disposition transaction.

In the case of a disposition or exchange of a digital currency for either cash, services or goods, this should give rise to a disposition where a gain or loss from a digital currency transaction will be treated as either (i) income or loss from business or property or (ii) a capital gain or loss. The difference comes with important tax implications.

The CRA stated that a vendor, who accepts bitcoin as payment for providing goods or services, must include the fair market value of those goods or services in their business income.

On the other hand, trading, investing, and speculating in digital currencies may straddle the line between income and capital. Canadian jurisprudence has churned out a large body of case law wrestling with the ambiguity between investing, which produces a capital gain or loss, and trading, which results in business income or expenses.

There are arguments, on both ends of the spectrum, for holders who mine digital currencies to be considered as acquiring a capital property (domestic or foreign) or earning business income. This, of course, comes back to a question of fact in making a determination of whether a disposition from a transaction in a digital currency gives rise to business or property income or a capital gain or loss.

Alternatively, a seller of goods and services that receives bitcoin or other digital currency would have their own independent analysis in how such transactions and expenses should be treated for their own tax purposes.

Ultimately, courts assess a wide range of factors when deciding whether to characterize a transaction's gains or losses as on an account of capital or income. Applied to bitcoin transactions, these factors may include:

Frequency of transactions—Whether there is a history of extensive buying and selling of bitcoins or of a quick turnover of properties.

Period of ownership—Whether the bitcoins are usually owned only for a short period of time.

Knowledge of bitcoin markets—Whether the taxpayer has some knowledge of or experience in the bitcoin markets.

Relationship to the taxpayer's other work—Whether the bitcoin transactions form a part of a taxpayer's ordinary business.

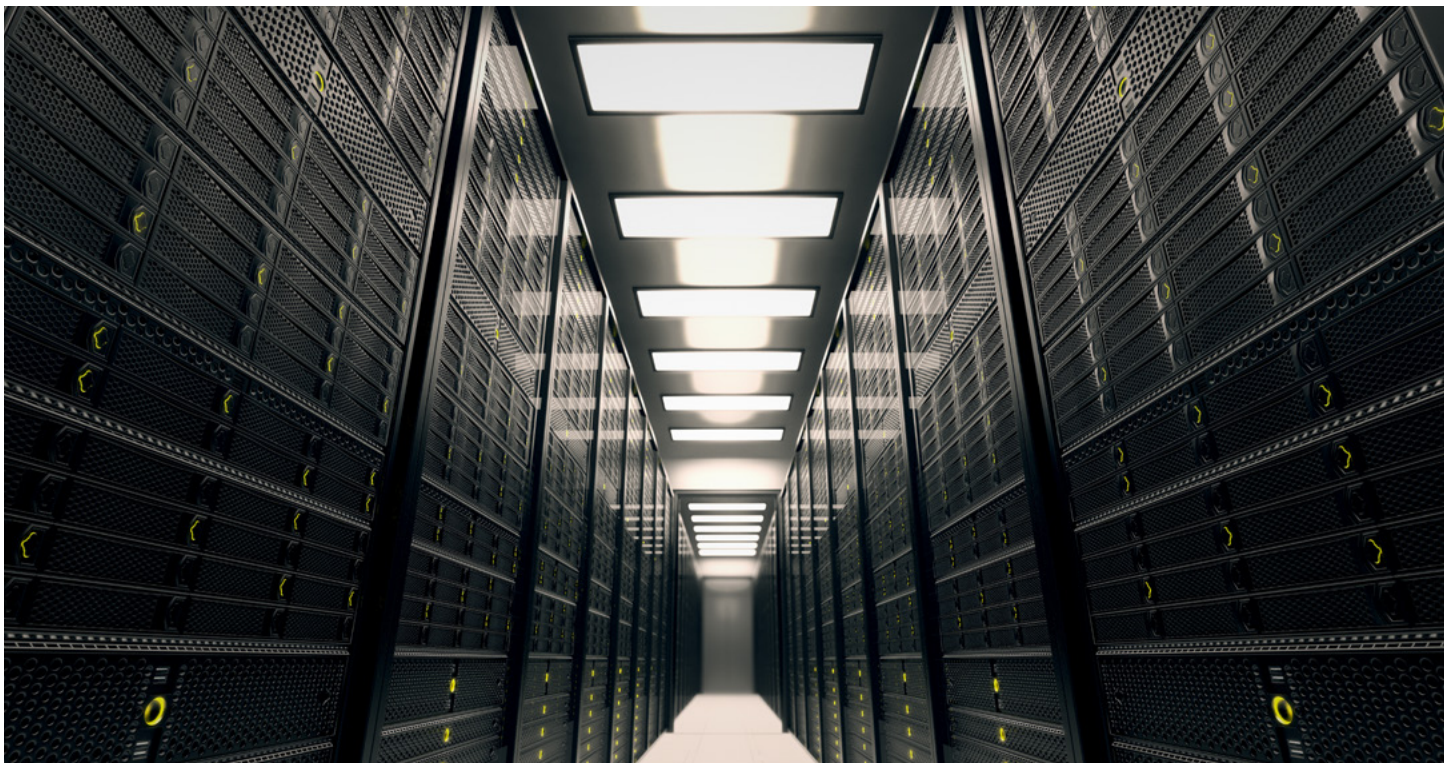
Time spent—Whether a substantial part of the taxpayer's time is spent studying the bitcoin markets and investigating potential purchases.

Financing—Whether the bitcoin purchases are financed by some form of debt.

Advertising—Whether the taxpayer has advertised or otherwise made it known that he/she is willing to purchase bitcoins.

Goods and Services Tax/Harmonized Sales Tax

The CRA's view is that the GST/HST rules on barter transactions apply to bitcoins and other digital currencies. Accordingly, where a taxable supply of a good or service is made and the consideration for that supply is a digital currency, the consideration for the taxable supply of the good or service is deemed to be equal to the fair market value of the digital



currency at the time the supply is made for the purposes of determining the GST/HST payable for the supply. This position is consistent with the CRA's view on the income tax side around barter transactions.

Aside from its position on barter transactions, the CRA has issued minimal guidance on the GST/HST implications of digital currency transactions. A key question for GST/HST purposes is whether digital currencies constitute money or currency as the answer to this question is central to determining whether a supply of digital currencies is taxable or exempt as a financial service. A financial service under the GST/HST is defined to include "the exchange, payment, issue, receipt or transfer of money, whether effected by the exchange of currency, by crediting or debiting accounts or otherwise."

While the CRA has implied that digital currencies do not meet the definition of money, it has not specifically addressed the question of whether a supply of a digital currency is taxable or exempt as a financial service. As a result, uncertainty exists in a number of key areas:

- Is bitcoin mining and the sale of digital currencies a "taxable supply"?
- If the mining or creation of digital currencies is considered to be a taxable supply, who is the recipient of that supply?
- Is the supply of digital currencies to a non-resident zero-rated or otherwise relieved from GST/HST?

- Are digital currency traders, many of whom are non-residents, required to register and collect and remit GST/HST on their supplies of digital currencies?
- If the supply of digital currencies is taxable, what method should be used to value the digital currencies for the purposes of determining the GST/HST payable on the supply?
- Are fees relating to digital currency transactions consideration for a taxable supply and therefore subject to GST/HST?

The current GST/HST framework does not provide clear and predictable guidance on how the GST/HST applies to the mining and supply of bitcoins and other digital currencies. Clarification in the form of guidance from the CRA or amendments to the GST/HST legislation would therefore be welcome.

Virtual currencies are a new and evolving medium in which to transact between peer to peer. Regulatory and legal frameworks are evolving across the globe and emerging opinions on the appropriate tax policy approach are still under development. Moreover, depending on how the technology evolves, regulations are developed and enforced on their use and universal acceptance as an instrument. It's quite likely that reasonable tax positions used by taxpayers today may otherwise change as a result of such evolutions.

Contact us

Joseph Micallef
Partner,
National Tax Leader,
Financial Services
KPMG in Canada
T: 416-777-8037
E: jmicallef@kpmg.ca

John Bain
Partner,
National Leader,
Indirect Tax,
KPMG in Canada
T: 416-777-3894
E: jbain1@kpmg.ca

Frankie Davenport
Senior Manager,
Tax Transformation
& Technology,
KPMG in Canada
T: 416-777-8047
E: frankiedavenport@kpmg.ca

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