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TAX MATTERS

Be aware of crypto-asset tax rules as you prepare your return this year

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There are some pretty funny tax rules around the world. I think of the tethered hot-air balloon tax in Kansas (if you're airborne, you'll avoid the sales tax, but sitting in a balloon tethered to the ground is taxable). Then there was the cow flatulence tax that nearly became law in Denmark a few years ago.

Closer to home, we've had our share of hilarity. Consider the (now repealed) Manitoba Odour Control Tax Credit.

Now, one set of rules that are not as amusing – especially if you don't understand them – are the tax rules around crypto assets. Given that it's tax time, let me share a primer on how your tax return might be affected.

The assets

Over time there's been growth in the number and types of crypto assets available. The taxman has spent a lot of time trying to keep up with the technology and how these assets should be taxed.

The Canada Revenue Agency has said that crypto assets include, but aren't limited to, cryptocurrencies; non-fungible tokens (NFTs – unique digital assets that are associated with digital art, items in blockchain-based games, fractional ownership of real estate, and more); utility tokens (assets that serve a specific function such as providing access to a product or service on a platform); and security tokens (tokenized securities that might, for example, derive their value from underlying stocks, bonds or some other investment opportunity).

Transacting in any type of crypto asset is going to eventually have tax implications. But what events can give rise to taxes?

The events

When you acquire a crypto asset, similar to buying a stock or bond, there's generally no taxable event at that time (except when cryptocurrency mining). But a disposition of that asset could give rise to a profit or loss, which will generally have to be reported on your tax return. Five types of events count as a disposition:

- trading one cryptocurrency or crypto asset for another;

- cashing out your cryptocurrency or crypto asset (converting it to government-issued currency);
- buying goods or services with your cryptocurrency or crypto assets;
- gifting your cryptocurrency or crypto assets to someone else or a charity;
- dying while owning crypto assets.

If there's been an increase in the value of your crypto assets between the date you acquired them and the date of disposition, then you'll have a profit, which will be taxed as either business income or a capital gain. A decline in value could mean a business loss or capital loss to report.

Consider the example of someone who acquired $30,000 worth of bitcoin a few years ago to hold for the long term. It's now worth $50,000. She wants to buy a car for $50,000 and the dealer has agreed to accept bitcoin as payment. When she makes payment with her bitcoin, she has a taxable disposition of that cryptocurrency, and the $20,000 profit will have to be reported as a capital gain in the year she buys the car (she'll pay tax on half of this capital gain).

The character

The character of any profit on a crypto-asset disposition would either be business income or a capital gain (with the same distinction for any loss). But which is it? There are principles that have been long established in Canada to determine whether the disposition of an asset should be treated as income or capital in nature.

I like to think of a tree and fruit analogy. If you buy a tree with the intention of growing fruit and selling the fruit for a profit, then the tree is generally a capital asset. If you sell the tree at a profit later, you'll realize a capital gain on the sale of the tree. But what if you're in the business of selling trees? If you bought the tree to flip it for a profit, and not to grow fruit, then the profit on the sale of the tree would be considered business income. This issue deserves a whole discussion on its own, so I'll visit this next week.

The records

Finally, when it comes to every crypto transaction, the taxman expects you to keep records of the following: the number of units and type of crypto asset; the date and time; the value (in Canadian dollars) of the crypto asset on the transaction date; the addresses associated with each digital wallet used; and the beginning wallet balance (and its cost) and ending balance for each crypto asset for each year.

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