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Policy Forum: The Income Taxation of Crypto Contracts

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PRÉCIS

Les lignes directrices actuelles de l'Agence du revenu du Canada (ARC) laissent entendre que les cryptoactifs (tels que le bitcoin) devraient généralement être imposés comme des marchandises aux fins de la Loi de l'impôt sur le revenu. Toutefois, les récentes modifications apportées à la réglementation des entités qui facilitent l'achat et la vente de cryptoactifs (les plateformes d'échange de cryptoactifs) en vertu du droit des valeurs mobilières ont permis d'appréhender différemment les transactions portant sur des cryptoactifs. De nombreuses plateformes d'échange de cryptoactifs détiennent des cryptoactifs pour le compte d'utilisateurs au lieu de les leur livrer directement, et les Autorités canadiennes en valeurs mobilières ont estimé que cette relation entre les plateformes d'échange de cryptoactifs et leurs utilisateurs constituait en soi une valeur mobilière. À ce jour, l'ARC n'a publié aucune directive concernant l'imposition de ces valeurs mobilières, connues sous le nom de « contrats sur cryptoactifs ». Cet article examine les implications fiscales potentielles découlant de l'existence des contrats sur cryptoactifs en explorant comment l'imposition des revenus serait différente pour les utilisateurs des plateformes d'échange de cryptoactifs s'ils étaient imposés sur les contrats sur cryptoactifs plutôt que sur les cryptoactifs. Plus précisément, l'article examine le traitement des transactions en tant que revenu ou capital, la possibilité de choisir de traiter les opérations en tant que capital, l'applicabilité de l'article 49.1 de la Loi de l'impôt sur le revenu, et l'imposition des récompenses de participation (*staking rewards*) gagnées par l'intermédiaire des plateformes d'échange. Plutôt que de proposer des conclusions sur ces sujets, cet article vise à fournir un cadre de réflexion sur les contrats sur cryptoactifs du point de vue de l'impôt sur le revenu canadien et à susciter une plus grande réflexion chez les fiscalistes canadiens.

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ABSTRACT

Current Canada Revenue Agency (CRA) guidance suggests that cryptoassets (such as bitcoin) should generally be taxed as commodities for the purposes of the Income Tax Act. However, recent changes in the regulation of entities that facilitate the purchase and sale of cryptoassets (crypto trading platforms) under securities law have introduced new ways of understanding transactions involving cryptoassets. Many crypto trading platforms hold cryptoassets on behalf of users rather than delivering the cryptoassets directly to them, and the Canadian Securities Administrators has taken the position that this relationship among crypto trading platforms and their users itself constitutes a security. To date, there has been no guidance from the CRA relating to the taxation of these securities, which are known as "crypto contracts." This article considers potential income tax implications arising from the existence of crypto contracts by exploring how income taxation would differ for users of crypto trading platforms if they were taxed on crypto contracts rather than cryptoassets. Specifically, the article considers the treatment of transactions as being on income or capital account, the availability of elections to treat transactions on capital account, the applicability of section 49.1 of the Income Tax Act, and the income taxation of staking rewards earned through crypto trading platforms. Rather than offering conclusions on these topics, this article aims to provide a framework for thinking about crypto contracts from a Canadian income tax perspective and to provoke further thought from Canadian tax professionals.

KEYWORDS: CAPITAL PROPERTY ■ COMMODITIES ■ DEBT ■ INVENTORY ■ INVESTMENT ■ SECURITIES

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INTRODUCTION

In a 2013 technical interpretation,[1] the Canada Revenue Agency (CRA) asserted that cryptoassets (such as bitcoins) are generally treated as commodities for the purposes of the Income Tax Act.[2] While this article does not suggest that this view is wrong, it does suggest that it lacks nuance.

Since 2013, the regulation of entities that facilitate the purchase and sale of cryptoassets (crypto trading platforms [CTPs]) under securities law has introduced new ways of understanding transactions involving cryptoassets. The most popular CTPs in Canada generally hold cryptoassets on behalf of users with a regulated third-party custodian. When a user purchases cryptoassets on these platforms, the cryptoassets are not delivered to the user's personal wallet but rather to a wallet maintained by a custodian and controlled by the CTP. The details of the transaction are concurrently recorded on the books of the CTP to evidence the purchase and the user's entitlement to receive the cryptoasset on demand. Pursuant to the terms of service of the CTP, the user is generally provided with a contractual right to withdraw those cryptoassets and have them delivered to the user's personal wallet (or to cause the sale of the underlying cryptoassets and withdraw the proceeds in fiat currency).

Thus, in a typical transaction involving a CTP, the purchaser can be understood to receive a contractual right to an underlying cryptoasset (known as a "crypto contract") rather than the cryptoasset itself. Hence, even if the underlying cryptoasset is a commodity, a purchaser using a CTP may instead be acquiring a derivative or a security. This distinction is important because the average taxpayer is more likely than not to interact with cryptoassets through a CTP.[3]

1 CRA document no. 2013-0514701I7, December 23, 2013.

2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act. This article uses the term "cryptoassets" in the same manner as the Canadian Securities Administrators (CSA). At the time of writing, cryptoassets are understood to include "bitcoin, ether, and anything commonly considered a crypto asset, digital or virtual currency, or digital or virtual token that are not themselves securities or derivatives": *Virgo CX Inc. (Re)*, 2022 BCSECCOM 222 (CanLII), at paragraph 7.

3 Survey results released by the Ontario Securities Commission on October 19, 2022 show that "[a]bout half of crypto asset owners (52%) acquired them through a centralized crypto trading platform, and generally stored them on the exchange or trading platform from where they were purchased." Ontario Securities Commission, *Crypto Asset Survey*, *Ontario Securities Commission Final Report* (Toronto: Ontario Securities Commission, 2022), at 11. Survey results from the Bank of Canada show that more than half of bitcoin owners obtained the cryptoasset using a crypto trading platform. Daniela Balutel, Walter Engert, Christopher Henry, Kim P. Huynh, and Marcel C. Voia, *Private Digital Cryptoassets as Investment? Bitcoin Ownership and Use in Canada*, *2016-2021*, Bank of Canada Working Paper 2022-44 (Ottawa: Bank of Canada, 2022). The Bank of Canada survey suggests that the median value of bitcoin held by Canadians was about $503 as of 2021. Almost a quarter (24 percent) of Canadian bitcoin owners held less than $100 worth of bitcoin, and more than half of Canadian owners held less than $1,000. The survey results also show that the median bitcoin holdings of Canadians nearly doubled in value

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The purpose of this article is to consider some potential income tax implications arising from this distinction, including

- the treatment of transactions as being on income or capital account;
- the availability of elections to treat transactions on capital account;
- the applicability of section 49.1 of the Act; and
- the income taxation of staking rewards earned through CTPs.

This article will not offer conclusions on any of these items but instead raises them as areas requiring further thought from Canadian tax professionals. Prior to considering each item, however, this article will proceed by explaining the genesis of crypto contracts as well as the CRA's current guidance on the income taxation of cryptoassets.

WHAT IS A CRYPTO CONTRACT? THE SECURITIES REGULATORS' APPROACH TO CRYPTOASSETS

The concept of crypto contracts derives from a staff notice released by the Canadian Securities Administrators (CSA) in 2020 that provided guidance on when cryptoasset transactions would be subject to securities legislation.[4] Therein, the CSA asserts that transactions in cryptoassets will be subject to securities regulation where any of the following conditions are met:[5]

1. the cryptoasset itself is a security, such as a token that carries rights traditionally attached to common shares, such as voting rights and rights to receive dividends;
2. the cryptoasset is a derivative, such as a token that provides an option to acquire an asset in the future; or
3. the cryptoasset is not itself a security or a derivative, but the transaction occurs on a CTP that merely provides its users with a contractual right to an underlying cryptoasset (rather than immediately delivering the cryptoasset to the users of the platform).

As noted above, the "contractual right" referred to in the third point above is what is now known in Canadian securities law as a "crypto contract."

from 2019 to 2021. In addition, the proportion of Canadian bitcoin owners holding more than $10,000 worth of bitcoin increased from 8 percent to 22 percent from 2019 to 2021. Thus, the survey suggests that, while bitcoin holdings by a typical Canadian owner are relatively small, these holdings have been increasing considerably in value over the past two years.

4 Canadian Securities Administrators, *CSA Staff Notice 21-327 Guidance on the Application of Securities Legislation to Entities Facilitating the Trading of Crypto Assets* (Montreal: CSA, 2020), at 2 (www.osc.ca/en/securities-law/instruments-rules-policies/2/21-327/csa-staff-notice-21-327-guidance-application-securities-legislation-entities-facilitating-trading) (herein referred to as "staff notice 21-327").

5 Ibid., at 1.

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In contrast, the CSA proposes that a transaction to buy or sell bitcoin at a given price where the terms of the transaction require that the entire quantity of bitcoin is immediately delivered to a wallet that is in the sole control of the transferee may not be subject to securities legislation.[6] Therefore, the idea of crypto contracts is important for Canadian securities law because it is the tool by which CSA members assert jurisdiction over transactions involving cryptoassets where the underlying cryptoassets are viewed as commodities.[7] (As an aside, it is worth mentioning that many securities lawyers in private practice disagree with the CSA's position on crypto contracts, viewing the concept as a convenient fiction by which the CSA is able to regulate an industry that raises obvious investor protection concerns.)[8]

Interestingly, the CSA posits that crypto contracts may be derivatives or securities without taking a definitive position either way. One comment in the staff notice suggests that crypto contracts may be derivatives: "Securities legislation may also apply to Platforms that facilitate the buying and selling of crypto assets, including crypto assets that are commodities, because the user's contractual right to the crypto asset may itself constitute a derivative."[9] Elsewhere, the CSA asserts that, in certain jurisdictions, crypto contracts may be considered to be a security, because (among other reasons) they may be viewed as "evidence of indebtedness."[10] Thus, according to the

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6 Ibid., at 3.

7 The CSA has (at least tacitly) endorsed the principle that certain cryptoassets should be treated as commodities. For example, in staff notice 21-327, supra note 4, at 1, the CSA states that "[s]ecurities legislation may also apply to [CTPs] that facilitate the buying and selling of crypto assets, *including crypto assets that are commodities*, because the user's contractual right to the crypto asset may itself constitute a derivative [emphasis added]." In effect, the securities regulators in Canada posit that there are at least two types of cryptoassets—those that are securities or derivatives and those that are not, with the latter being implicitly categorized as commodities. This article deals only with cryptoassets that are not themselves securities and/or derivatives (that is, cryptoassets that are treated as commodities for both Canadian income tax and Canadian securities-law purposes). Whether or not a Canadian securities regulator will view a cryptoasset as a commodity depends on a number of factors, many of which are set out in Canadian Securities Administrators, *CSA Staff Notice 46-308 Securities Law Implications for Offerings of Tokens* (Montreal: CSA, 2018), at 2. In most cases, the determination will hinge on whether or not the cryptoasset meets the investment contract test set out in the Supreme Court of Canada's decision in *Pacific Coast Coin Exchange v. Ontario Securities Commission*, [1978] 2 SCR 112.

8 For example, these practitioners could argue (quite convincingly) that indirect holdings of stocks and bonds by investors through brokers and the Canadian Depository for Securities are not treated by the CSA as a distinct type of security by virtue of their contractual nature (even though, for example, the Securities Transfer Act (Ontario), 2006, SO 2006, c. 8, makes it clear that only a claim to the securities exists).

9 Staff notice 21-327, supra note 4, at 1.

10 Ibid. The CSA also suggests that a crypto contract may be a security by virtue of being "an investment contract or evidence of indebtedness or evidence of title to or interest in the assets or property of another person" (ibid.). While the idea that crypto contracts may be viewed as "evidence of indebtedness" might seem far-fetched at first glance, a closer inspection of crypto

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CSA, a crypto contract may be characterized as a derivative, a security other than a debt obligation, or a security that is a debt obligation. Each of these characterizations is considered below (under the heading "Income Versus Capital Account").

THE TREATMENT OF CRYPTOASSET TRANSACTIONS BY THE CRA

The CRA generally treats cryptoassets as commodities. As noted above, the CRA first adopted this view in a technical interpretation relating to Bitcoin in 2013, where it asserted that "[v]irtual currencies, such as Bitcoins [sic], are not considered to be a currency issued by a government of a country, such as American dollars. As such, they are generally treated as a commodity for purposes of the *Income Tax Act*."[11] The view is also repeated in the CRA's *Guide for Cryptocurrency Users and Tax Professionals* published in 2021.[12]

The apparent divergence in the regulation of cryptoasset transactions by the CRA and the CSA stems from the fact that the CRA does not distinguish transactions that

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contracts shows that they have many of the fundamental qualities of debt. In *Barejo Holdings ULC v. The Queen*, 2015 TCC 274, at paragraph 129 (aff'd 2016 FCA 304), the Tax Court of Canada set out the following "essential characteristics" of debt for the purposes of the Act:

(i) an amount or credit is advanced by one party to another party;
(ii) an amount is to be paid or repaid by that other party upon demand or at some point in the future set out in the agreement in satisfaction of the other party's obligation in respect of the advance;
(iii) the amount described in (ii) is fixed or determinable or will be ascertainable when payment is due; and
(iv) there is an implicit, stipulated, or calculable interest rate (which can include zero).

In the crypto contract framework,

(i) the user advances funds to the CTP;
(ii) an amount of cryptoassets is to be paid by the CTP upon demand by the user in satisfaction of the CTP's obligation in respect of the advance;
(iii) the amount described in (ii) is fixed at the amount of cryptoassets acquired by the CTP using the advanced funds (less transaction fees); and
(iv) there is an implicit interest rate equal to zero.

In a subsequent case, *Barejo Holdings ULC v. Canada*, 2020 FCA 47, at paragraph 92, the Federal Court of Appeal found that "there is no requirement under the civil law or the common law, that there be an interest component in the amount to be paid or repaid in order for a debt to exist." The court also found that the meaning of "debt" may differ depending on the specific use of the term; thus, the determination of the meaning of "debt" requires a textual, contextual, and purposive analysis of the provision(s) of the Act in question.

11 CRA document no. 2013-0514701I7, December 23, 2013.

12 "The CRA generally treats cryptocurrency like a commodity for purposes of the Income Tax Act." Canada Revenue Agency, "Guide for Cryptocurrency Users and Tax Professionals" (www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/digital-currency/cryptocurrency-guide.html) (herein referred to as "the cryptocurrency guide").

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involve the immediate delivery of underlying cryptoassets from those that do not. This fact is made clear in the cryptocurrency guide, which, after stating that cryptoassets are generally considered to be commodities, is largely devoted to distinguishing transactions as being on income or capital account and explaining how transactions involving cryptoassets may fall under the barter transaction rules.[13] Thus, the cryptocurrency guide only considers cryptoasset transactions as involving the purchase and sale of commodities. By restricting its review in this manner (and despite mentioning "cryptocurrency exchanges" multiple times),[14] the CRA does not address the complexities introduced by taxpayers transacting in cryptoassets through CTPs.[15]

INCOME VERSUS CAPITAL ACCOUNT

Users generally engage with CTPs by buying and selling contracts rather than by exercising their contractual right to withdraw the underlying cryptoassets from the platform.[16] As a result, if CTP users are considered to transact in derivatives or securities as opposed to commodities, a question of primary concern is whether they are transacting on income or capital account. Indeed, there should be no difference in the quantum of tax payable by (1) a taxpayer selling a crypto *contract* held as capital property with an adjusted cost base of (say) $1,000, for proceeds of disposition of $2,000; and (2) a taxpayer selling a crypto *asset* held as capital property with the same adjusted cost base and for the same proceeds. However, if the method for determining whether a crypto contract is held as capital property is different from the method for determining whether a cryptoasset is held as capital property, the difference in tax liability could be significant. Accordingly, this article proceeds by first examining the CRA guidance on the characterization of transactions in cryptoassets before considering each of the three characterizations of a crypto contract offered by the CSA (as a derivative, a security other than a debt obligation, or a security that is a debt obligation).

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13 Ibid.

14 Ibid.:

> Some examples of cryptocurrency businesses are: . . .
>
> - cryptocurrency exchanges.
>
> Cryptocurrencies are commonly acquired in two ways:
>
> - bought through a cryptocurrency exchange.
>
> Cryptocurrency exchanges have different standards for the kinds of records they keep and how long they keep them. If you use cryptocurrency exchanges, we suggest that you export information from these exchanges periodically to avoid losing the information necessary to report your transactions.

15 But see supra note 8. Arguably, the complexities of the arrangements through which traditional equities are held are also ignored under the Canadian income tax system. Why, then, should crypto contracts be treated differently?

16 See supra note 3.

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Current CRA Guidance

In the cryptocurrency guide, the CRA essentially adopts a general principles-based approach to determining whether cryptoassets are held on income or capital account.[17] The CRA suggests that income derived "from disposing of cryptocurrency may be considered business income or a capital gain" and provides a number of factors that can be used to determine whether the taxpayer is carrying on a business.[18] The CRA also directs its readers to paragraphs 9 to 32 of *Interpretation Bulletin* IT-479R for general information relating to the determination of whether transactions result in income or capital gains.[19]

This reference to IT-479R is somewhat surprising in that it relates to transactions in securities as opposed to transactions in commodities, which are addressed in *Interpretation Bulletin* IT-346R.[20] Nevertheless, the guidance in the cryptocurrency guide and IT-479R generally follows the case law developed over time for non-cryptoassets.[21] Taxpayers and tax professionals are directed to analyze a list of factors to determine whether the asset is held on income or capital account, including[22]

- how frequently the taxpayer undertakes similar transactions;
- the period of ownership of the asset;
- whether the taxpayer has some knowledge of or experience in the markets for the asset;
- whether such transactions form part of a taxpayer's ordinary business;
- whether the taxpayer spends a substantial part of his or her time studying the markets for the assets and investigating potential purchases;
- whether purchases are financed primarily on margin or by some other form of debt; and
- whether the taxpayer has advertised or otherwise made it known that he or she is willing to purchase the assets.

Crypto Contracts as Derivatives

What if a crypto contract should properly be characterized as a derivative? As a derivative, a crypto contract should be subject to factors similar to those applied to other derivatives in determining whether it is held on income or capital account.

17 The cryptocurrency guide, supra note 12.

18 Ibid.

19 *Interpretation Bulletin* IT-479R, "Transactions in Securities," February 29, 1984, at paragraphs 9-32.

20 *Interpretation Bulletin* IT-346R, "Commodity Futures and Certain Commodities," November 20, 1978.

21 See, for example, *MNR v. Taylor*, 56 DTC 1125 (Ex. Ct.). Also see, for example, *Vancouver Art Metal Works Ltd. v. Canada*, [1993] 2 FC 179; *Sandnes v. The Queen*, 2004 TCC 244; and *Kane v. The Queen*, 94 DTC 6671 (FCTD).

22 IT-479R, supra note 19, at paragraph 11.

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Although there is no equivalent to IT-479R for derivatives, the CRA released IT-346R to assist in determining whether commodity futures (as well as underlying commodities) are held on income or capital account.[23] Crypto contracts are similar to commodity futures insofar as (1) they require the delivery of a specified quantity of a commodity at a future time, and (2) their terms and conditions are standardized according to the procedures of the platform through which they are traded.[24] Given these similarities, the administrative position established in IT-346R for commodity futures could arguably extend to crypto contracts.

In IT-346R, the CRA asserts that the following taxpayers will generally be required to treat gains and losses from commodity futures trading on income account:[25]

- taxpayers who take future positions in, or who have transactions in, commodities connected with their business as part of their business operations (for example, a distiller who takes a future position in grains);
- taxpayers who, while not carrying on a business that utilizes a particular commodity, have access to insider information about the commodity that they use to their benefit in one or more transactions (for example, a senior officer of a sugar refinery who personally enters into transactions in sugar futures or sugar); and
- corporate taxpayers whose primary business activity is trading in futures.

By contrast, a taxpayer who takes a future position but is not one of the three types identified above (such taxpayers being referred to by the CRA in IT-346R as "speculators")[26] is generally entitled to treat gains and losses from commodity futures or commodities trading as being on either income or capital account,[27] provided that this treatment is followed consistently across taxation years.[28]

23 IT-346R, supra note 20.

24 Compare the CSA's description of crypto contracts above with, for example, the definition of "commodity futures contract" in the Commodity Futures Act (Ontario), RSO 1990, c. C.20, section 1(1): "[A] contract to make or take delivery of a specified quantity and quality, grade or size of a commodity during a designated future month at a price agreed upon when the contract is entered into on a commodity futures exchange pursuant to standardized terms and conditions set forth in such exchange's by-laws, rules or regulations." Of course, the primary difference between crypto contracts and commodity futures contracts according to this definition is that, in the case of a crypto contract, the delivery need not occur at a specific time (but rather on demand).

25 IT-346R, supra note 20, at paragraphs 3-5.

26 Ibid., at paragraph 7.

27 Ibid., at paragraphs 6-7. Some would question whether the CRA's position is correct, given that the only way to generate income from a commodity future is by its sale—suggesting that it should be treated as inventory.

28 Ibid., at paragraph 8.

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Crypto Contracts as Securities Other Than Debt Obligations

As noted above, the CSA suggests that a crypto contract may be viewed as a security that is not a debt obligation. To the extent that a crypto contract is a security, the factors that the CRA should presumably want taxpayers to examine are those set forth in IT-479R. Therefore, it seems that taxpayers could rely on the CRA's guidance with respect to cryptoassets in determining whether they hold their crypto contracts on income or capital account.

Crypto Contracts as Debt Obligations

The final characterization identified by the CSA is that a crypto contract may be a security because it is evidence of indebtedness (that is, a debt obligation).[29] While little explanation for this characterization is provided by the CSA, the basis for considering crypto contracts to be debt obligations presumably derives from the fact that CTP users advance funds to a CTP in exchange for an obligation to demand repayment (in cryptoassets) at a future time.[30] Under this framework, the CTP user would be the creditor and the CTP would be the debtor.

Apart from a cancelled interpretation bulletin dealing with discounts, premiums, and bonuses of debt obligations,[31] the CRA has not released official guidance specifically addressing the characterization of debt as being held on income or capital account. Recent literature on the treatment of debt obligations as being on capital or income account suggests that courts tend to undertake a fact-driven analysis to characterize debt obligations on the basis of lines of case law relating to foreign exchange gains and losses, debt forgiveness, and hedging transactions.[32]

As a result, it seems that the analysis needed to characterize debt as being held on income or capital account may be more opaque than that for other securities, commodity futures, and commodities. The cases dealing with foreign exchange gains and losses, debt forgiveness, and hedging transactions can be difficult to uncouple from their factual contexts, which are often tied to highly particular circumstances related to the taxpayer's business. For example, the Supreme Court of Canada had to consider,

29 Staff notice 21-327, supra note 4, at 1.

30 See supra note 10 for an in-depth discussion of why crypto contracts might validly be characterized as debt obligations.

31 A 1973 interpretation bulletin (*Interpretation Bulletin* IT-114 (Cancelled), "Discounts, Premiums and Bonuses on Debt Obligations," August 3, 1973) was cancelled by the CRA because "it did not reflect significant changes to the Income Tax Act and was no longer a useful guide to the taxation of discounts, premiums and bonuses relating to a multiplicity of financial products that [had] changed considerably": CRA document no. 2005-0152201E5, October 26, 2005.

32 See, for example, Shaira Nanji, "Capital vs. Income Determinations Related to Debt," in *2020 YP Focus Virtual Conference* (Toronto: Canadian Tax Foundation, 2020), 3B: 1-27; and Richard Marcovitz, "Taxation of Liabilities and Derivatives on Income Account," in *Report of Proceedings of the Sixty-Ninth Tax Conference*, 2017 Conference Report (Toronto: Canadian Tax Foundation, 2018), 12:1-27.

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in *Gifford*,[33] whether interest on money borrowed by a financial adviser to finance the acquisition of a client list was paid on income account and, in *Tip Top Tailors Ltd.*,[34] whether a foreign exchange gain was on capital account where a clothing manufacturer purchased textiles and other supplies using a line of credit. Moreover, many of the leading cases on the characterization of debt tend to deal with corporations and interest payments, making it difficult to adapt those decisions to holders of crypto contracts.[35] Take the court's conclusion in *Gifford* as an example. Although it may seem straightforward that interest payments will be on account of capital where the loan proceeds add to the financial capital of the borrower, it is not entirely clear how this position might apply to the average CTP user (a "lender" who will not receive interest payments and will most likely recognize a gain or loss only on the disposition of a crypto contract).

There is, however, a line of older cases dealing with discounts received by lenders in respect of debt obligations (usually mortgages) that seem to address more aptly the circumstances of CTP users.[36] These cases better fit the situation of the CTP user because they often consider whether an individual who lends money or acquires debt obligations is doing so as an *investor*. In *Sissons*, Pigeon J of the Supreme Court of Canada succinctly captured the test generally used in these cases:

> For the respondent to escape taxation on his gain from the operation he has to show that it is to be characterized as an investment. Otherwise, the conclusion is inescapable that it is an adventure in the nature of trade.[37]

The cases also involve, in certain circumstances, a determination of whether a taxpayer acquired the relevant debt obligation(s) in the course of carrying on a business.[38] Here, then, we are brought back to first principles—the fruit versus the tree, an adventure or concern in the nature of trade, etc.

But we need not rely only on first principles. Examining this line of cases reveals factors that the courts return to in making their income-versus-capital determinations in the debt context. In fact, the CRA does an adequate job of describing these factors in the cancelled interpretation bulletin referred to above. Factors indicating that a

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33 *Gifford v. Canada*, 2004 SCC 15.

34 *Tip Top Tailors Limited v. The Minister of National Revenue*, [1957] SCR 703.

35 *Gifford*, supra note 33, at paragraph 39.

36 These cases include *Scott v. Minister of National Revenue*, [1963] SCR 223; *Wood v. MNR*, [1969] SCR 330; *Minister of National Revenue v. MacInnes*, [1963] SCR 299; *Minister of National Revenue v. Sissons*, [1969] SCR 507; *Baynham et al. v. The Queen*, 98 DTC 1169 (TCC); *Bardot Realty Ltd. v. MNR*, 72 DTC 6079 (FCTD); and *Dally*, sub nom. *527208 Ontario Ltd. et al. v. MNR*, 91 DTC 723 (TCC).

37 *Sissons*, supra note 36, at 512.

38 For the purposes of the Act, a business includes an adventure or concern in the nature of trade (subsection 248(1), the definition of "business").

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creditor is an investor (and is thus holding the debt obligation on capital account) include

(a) the investment in debt obligations was made from funds derived from savings rather than borrowings,
(b) the investment in debt obligations is only a minor part of a taxpayer's normal income earning activity, or
(c) purchases of debt obligations are made only infrequently.[39]

The interpretation bulletin also identifies factors that show that the creditor has acquired the debt obligation as a "trader or dealer" (and is thus holding the debt obligation on income account). These factors include[40]

- "the ownership of a fairly large number of purchased obligations";
- the sale of some obligations before maturity;[41]
- borrowing a substantial portion of the funds required for the purchase;
- advertising or otherwise making known the wish to purchase obligations;
- the amount of time devoted by the taxpayer; and
- "creation of a partnership of two or more persons."

As a result, if crypto contracts were to be characterized as debt obligations, it would be necessary to undertake a different analysis than those identified above. Particularly, taxpayers seeking capital treatment for their crypto contracts as debt obligations would want to prove that they have made investments in crypto contracts from savings rather than borrowings, that their investments form only a minor part of their income-earning activities, and that their purchasing is done infrequently.

Summary

The foregoing analysis indicates that taxing crypto contracts rather than cryptoassets could potentially result in different tax liability for CTP users. The outcome will

39 IT-114, supra note 31, at paragraph 15. IT-114 also has a section dealing with "original loan," which provides a presumption in favour of income treatment where the taxpayer is the original lender (rather than having acquired the debt obligation in a secondary transaction). Ibid., at paragraph 6. The basis for this presumption is that the original lender is in a position to negotiate the premium, bonus, or discount associated with the debt obligation. This consideration should be ignored in the crypto contract context because the CTP user has no latitude to dictate the terms of the contract. All of these factors were present in *Wood*, supra note 36: "The appellant's investments, including investments in mortgages, were made entirely from savings not from borrowings, and his income from this source, including income from stocks and bonds, was a relatively modest part of his gross income. During the period from 1956 to 1963 inclusive, the appellant acquired eight first mortgages and five second mortgages all but two of them at a discount or bonus. This represents an average of one and one-half mortgages per year." Ibid., at 333-34.

40 IT-114, supra note 31, at paragraph 13.

41 Arguably, this factor would be inapplicable in the crypto contract context.

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depend on whether crypto contracts are properly characterized as derivatives, securities that are not debt obligations, or securities that are debt obligations under the Act. If crypto contracts are characterized as derivatives or debt obligations, taxpayers will need a different method than the one currently suggested by the CRA to determine whether their transactions should be taxed on income or capital account. Moreover, and as discussed in the next section, taxpayers may have greater flexibility to elect that their transactions be taxed on capital account.

Notwithstanding these potential outcomes, one might argue that, from a policy perspective, transactions involving cryptoassets should not be taxed differently simply because they are framed as transactions in commodities, derivatives, securities that are not debt obligations, or securities that are debt obligations. Indeed, there does not seem to be a compelling reason why Canadian residents who hold cryptoassets for speculative purposes ought to be treated differently (in terms of income-versus-capital treatment) than Canadian residents who hold crypto contracts for speculative purposes.

ELECTIONS FOR CAPITAL TREATMENT

To date, much of the literature published by the Canadian tax community on the taxation of cryptoassets has dwelt on the question of income-versus-capital treatment.[42] This topic has been of particular interest at least partly because of the lack of opportunity for taxpayers to elect to have their transactions involving cryptoassets taxed on capital account. As the CRA pointedly remarks in the cryptocurrency guide, "cryptocurrencies are not Canadian securities under the Income Tax Act."[43]

This state of affairs could be considered to unduly affect investors in cryptoassets as compared with investors in traditional equity and debt securities. The latter may be eligible to benefit from the election in subsection 39(4), which allows taxpayers to elect to treat all transactions in Canadian securities (as defined in subsection 39(6)) on capital account. Subsection 39(6) defines a "Canadian security" to mean "a share of the capital stock of a corporation resident in Canada, a unit of a mutual fund trust or a bond, debenture, bill, note, mortgage, hypothecary claim or similar obligation issued by a person resident in Canada." As a result, Canadian residents eligible for the Canadian securities election could be considered to be disadvantaged to the extent that they prefer to invest in cryptoassets rather than traditional equity and debt securities issued by Canadian residents.

Elections to treat transactions on capital account could become available, depending on how crypto contracts are characterized under the Canadian income tax system. As noted above, if crypto contracts are considered to be similar to commodity futures,

42 See, for example, Vern Krishna, "Taxation of Cryptocurrency Transactions," March 19, 2018 (available on *Taxnet Pro*); and Paul J. Gibney and Kathryn S. Walker, "Canadian Taxation of Cryptocurrency" (2018) 7:1 *Personal Tax and Estate Planning* 2-7.

43 The cryptocurrency guide, supra note 12. This reference to "Canadian securities" is a reference to subsection 39(6).

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an informal election may be available pursuant to the CRA's administrative policy set out in IT-346R.[44] Alternatively, crypto contracts issued by Canadian CTPs could potentially meet the definition of a Canadian security if crypto contracts are treated as debt obligations. In these circumstances, crypto contracts may possibly be considered to be obligations similar to bonds, debentures, bills, notes, mortgages, or hypothecary claims.

THE APPLICABILITY OF SECTION 49.1

The framing of crypto contracts as debt obligations rather than as (or similar to) commodity futures could also potentially result in different tax treatment under section 49.1. As noted above, CTP users generally buy or sell crypto contracts, rather than exercise their contractual right to claim the underlying cryptoassets from the platform. However, CTP users may instead choose to withdraw their cryptoassets and sell the underlying cryptoassets directly.

Consider the following transactions involving a Canadian-resident individual who holds a contractual right to receive delivery of one bitcoin on demand (that is, a crypto contract) as capital property, with an adjusted cost base of $27,000:

> *Transaction A*
> Instead of demanding delivery of the bitcoin, the taxpayer sells the crypto contract back to the CTP in exchange for $25,000 (the value of one bitcoin at that time).
>
> *Transaction B*
> The taxpayer demands delivery of the bitcoin. At the time of delivery, the value of the crypto contract is equal to the value of the bitcoin ($28,000). After receiving the bitcoin, the taxpayer sells it to a third party for $25,000.

In analyzing these transactions, let us first assume that the crypto contract is a derivative or a security that is not a debt obligation. In these circumstances, there should be no difference in tax liability arising from transaction A and transaction B because of the application of section 49.1. This provision clarifies that a right to a particular property is not disposed of by a taxpayer as a consequence of the acquisition of the particular property by the taxpayer in satisfaction of an absolute or contingent obligation to provide the particular property, where the obligation is pursuant to a contract or other arrangement one of the main objectives of which was to establish that right and that right was not under the terms of a trust, partnership agreement, share, or debt obligation.[45] Put simply, if section 49.1 applies to crypto contracts, the taxpayer should not be taxed at the time that he or she receives delivery of the underlying cryptoasset because the taxpayer will not be considered to have disposed of the crypto contract. Instead, in our example, the taxpayer will be taxed only on the ultimate disposition of the underlying bitcoin, resulting in a capital loss of $2,000 in both cases.

44 IT-346R, supra note 20, at paragraph 8.

45 See section 49.1.

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In contrast, section 49.1 should not apply to transaction B if the crypto contract is treated as a debt obligation because debt obligations are excluded from the ambit of that provision. Consequently, the taxpayer may experience a taxable event at the time that he or she receives delivery of the underlying bitcoin pursuant to the crypto contract, resulting in a capital gain of $1,000. The taxpayer could then use the capital loss of $3,000 realized on his or her later disposition of the bitcoin (the difference between the taxpayer's adjusted cost base of $28,000 at that time and proceeds of disposition of $25,000) to offset the capital gain of $1,000, resulting in the same ultimate tax position as under transaction A (that is, an overall capital loss of $2,000).

Although this alternative treatment would not necessarily result in differing tax liabilities for the taxpayer in the example above, this could happen in other circumstances—for example, if the delivery and sale of the bitcoin in transaction B occurred in different taxation years. Further, the treatment of the crypto contract as a debt obligation could potentially result in taxpayers inadvertently triggering capital gains or capital losses.

CRYPTO CONTRACTS AND STAKING TRANSACTIONS

The blockchain networks associated with certain cryptoassets enable holders to earn rewards by participating in transaction confirmation activities through processes known as "staking" and "delegating." Before considering how these processes relate to crypto contracts and their taxation under the Act, this section of the article explains (1) how staking and delegation work, and (2) which provisions of the Act may apply to these types of transactions.

Staking and Delegation Explained

Staking generally refers to proof-of-stake (PoS) consensus protocols, which are mechanisms for ensuring that transactions are properly recorded on the blockchain. Owners who stake the blockchain's native currency validate the block transactions. Blockchain networks that employ PoS protocols generally rely on "validators." Validators are network node operators that serve to verify the accuracy of data being recorded on the blockchain. They are typically rewarded in cryptoassets for their transaction confirmation activities. In order to become a validator, a node operator is required to "stake" cryptoassets. The operator generally accomplishes this by locking cryptoassets on the relevant blockchain network (a process often referred to as "bonding"). Staked cryptoassets essentially function as a form of collateral: if validators act maliciously or incompetently, they may lose their staked cryptoassets and/or their access to the associated blockchain network.

Delegating refers to delegated proof-of-stake (DPoS) consensus protocols. DPoS protocols are similar to PoS protocols, but they also allow for holders to earn rewards without having to operate a network node. Staking requires validators to run their own hardware and software, and to maintain close to 100 percent uptime. The latter requirement can be difficult and costly for regular holders to satisfy. In such cases,

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the holder can commit (or "delegate") his or her cryptoassets to a validator, who will complete the transaction confirmation activities on the delegator's behalf. In exchange for delegating the cryptoassets to the validator, the delegator is entitled to a portion of the reward earned by the validator.

The Taxation of Staking Rewards Under the Act

The CRA has yet to release any (useful) guidance on staking or delegating in the income tax context. Indeed, while the CRA has published a FAQ ("frequently asked questions") that discusses staking,[46] this document merely directs readers to the cryptocurrency guide, in which the word "staking" does not appear at all.

The cryptocurrency guide does, however, address cryptoasset mining. Mining primarily differs from staking insofar as it requires would-be validators to solve complex computational problems in order to validate transactions and earn rewards. In other words, instead of the staking of cryptoassets being a prerequisite to validating transactions, the prerequisite for mining is the solving of computational problems. In the cryptocurrency guide, the CRA explains that the taxation of rewards earned through mining is dependent on whether the taxpayer is engaged in a personal activity or carrying on a business:

> The income tax treatment for cryptocurrency miners is different depending on whether their mining activities are a personal activity (a hobby) or a business activity. This is decided case by case. A hobby is generally undertaken for pleasure, entertainment or enjoyment, rather than for business reasons. But if a hobby is pursued in a sufficiently commercial and businesslike way, it can be considered a business activity and will be taxed as such.[47]

In this passage, the CRA is implicitly suggesting that rewards earned through mining will be included in a taxpayer's income by virtue of subsection 9(1), which provides that a taxpayer's income from a business or property is the taxpayer's profit from that business or property.

This rationale can also be applied to staking. A taxpayer who carries on staking activities in a business-like manner should be required to include the profits from those activities in income. Here, the taxpayer could be understood to earn business income in exchange for providing transaction confirmation services. While this argument may make sense for validators, it is hard to imagine how the delegation of cryptoassets constitutes the provision of a service. Cryptoasset holders who delegate their cryptoassets to validators are essentially collateralizing property in exchange for a fee. While the threshold for carrying on a business is very low, the passivity of delegation could lead to a characterization of staking rewards earned therefrom as income from property. As Ian Gamble explains,

46 Canada Revenue Agency, "What Is Cryptocurrency?" January 26, 2022 (www.canada.ca/en/revenue-agency/news/newsroom/tax-tips/tax-tips-2022/what-cryptocurrency.html).

47 The cryptocurrency guide, supra note 12.

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> [t]he notion of simply "drawing income from property" connotes the least possible amount of activity that one might imagine. The notion is of "a merely passive person" who is "merely holding" property and doing nothing at all in connection with it other than "simply drawing income that flows" from it.[48]

While learning how to delegate cryptoassets requires some level of technical know-how, it is not exactly a strenuous exercise for the technologically savvy. Nor does delegation require constant attention or activity on the part of the delegator.[49]

If not included in income by virtue of subsection 9(1), staking rewards could potentially be taxable under either paragraph 12(1)(g) or paragraph 12(1)(c). On the one hand, paragraph 12(1)(g) provides for the taxation of amounts received by a taxpayer that are "dependent on the use of or production from property." This provision could apply to staking rewards because they are dependent on the use of cryptoassets (that is, property) for staking. Validation activities are dependent on the use of cryptoassets because it is impossible to be selected as a validator without using those assets as collateral. On the other hand, paragraph 12(1)(c) provides for the taxation of amounts received or receivable "as, on account of, in lieu of payment of or in satisfaction of, interest." Staking rewards have a lot in common with interest, which has been defined as "compensation for the use . . . of money, belonging to . . . or owed to, another";[50] and (ii) "the return [of] consideration or compensation for the use or retention by one person of a sum of money, belonging to, in a colloquial sense, or owed to, another."[51] However, paragraph 12(1)(c) seems less likely to apply than paragraph 12(1)(g) on account of the CRA's position that cryptoassets "are not considered to be a currency issued by a government of a country."[52] In other words, it is doubtful that cryptoassets could be considered "money."

Staking Transactions Under the Crypto Contract Framework

On October 26, 2022, the CSA for the first time allowed certain registered CTPs to offer staking services to their users.[53] Pursuant to these services, CTPs act as intermediaries

48 Ian Gamble, "Income from a Business or Property: General Principles and Current Issues," in *Report of Proceedings of the Sixty-Sixth Tax Conference*, 2014 Conference Report (Toronto: Canadian Tax Foundation, 2015), 5:1-32, at 5:8. The quoted phrases in this passage are from the English Court of Appeal's decision in *IRC v. Desoutter Brothers, Ltd.*, [1946] 1 All ER 58, at 61 (CA), which is in turn cited in *Clevite Development Ltd. v. MNR*, [1961] CTC 147 (Ex. Ct.).

49 But see Gamble's discussion of the minimal degree of activity required to be considered to be carrying on a business: Gamble, supra note 48, at 5:5-9.

50 *Canada v. Sherway Centre Ltd.*, [1998] 3 FC 36, at paragraph 10, citing *Reference as to the Validity of Section 6 of the Farm Security Act, 1944 of Saskatchewan*, [1947] SCR 394, at 411.

51 *Cassan v. The Queen*, 2017 TCC 174, at paragraph 381, citing *Sherway*, supra note 50, at paragraph 10.

52 CRA document no. 2013-0514701I7, December 23, 2013.

53 See, for example, the terms and conditions published in the CSA's firm registration records for Bitbuy Technologies Inc. and Wealthsimple Digital Assets Inc., available at Canadian Securities

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between their users and one or more validators. In essence, CTPs will contract either directly or indirectly with validators to stake the cryptoassets held in the custodial wallets that they control.[54] Here, the CTP acts as a delegator of the cryptoassets held by its custodian, which are staked either by that custodian or by a third-party validator. For a fee, the CTP will then pass along a portion of the staking rewards earned on the cryptoassets held in those custodial wallets to their users. Notably, the CSA links the right to receive these rewards with a CTP user's rights under the agreed crypto contract.[55]

The inclusion of staking rewards under the crypto contract framework raises additional questions, further complicating an already obfuscated exercise in income taxation. Under the crypto contract framework, it cannot be said that the CTP user is delegating his or her own cryptoassets. Rather, the user is authorizing the CTP to delegate cryptoassets in respect of which the user has a contractual claim pursuant to a crypto contract. This process makes it even easier for the user to earn rewards: technical knowhow is replaced by a simple and inviting one-click solution offered by a service provider.

Does this lack of effort translate to a stronger argument that the rewards earned by CTP users are income from property? If these rewards are income from property, is the income being earned from a crypto contract or from the underlying cryptoassets? And how does one characterize the activities of the CTP? Is it earning income by providing "delegation services" to its users, or is it earning income by delegating the cryptoassets itself? Alternatively, to what extent can paragraph 12(1)(g) apply to staking rewards where a CTP user does not have direct ownership of the cryptoasset being used in the staking transactions? Can the payment of staking rewards to CTP users really be said to be "for the use or production from property" if those users never owned the property from which the payments are derived? And is the application of paragraph 12(1)(c) more relevant if crypto contracts are viewed as debt obligations? Further research will be required to resolve these questions.

CONCLUSION

The CRA's initial comments on cryptoassets are almost a decade old. During this period, Canadian securities law has advanced significantly and has formed new understandings of how Canadian residents interact with cryptoassets. Perhaps the most

Administrators, "National Registration Search" (https://info.securities-administrators.ca/nrsmobile/NrsSearch.aspx).

54 Ibid. "Under the Staking Services, clients will be able to identify the particular type of crypto assets (e.g., ETH) held under the Firm's Crypto Contracts with clients that they wish to allow to be staked under the Staking Services. The Firm will provide the Staking Services either through the crypto asset custodian(s) used by the Firm that offers staking, or through validators that operate blockchain validator nodes."

55 Ibid. "The Staking Services will be offered in relation to the Crypto Assets . . . that are subject to a Crypto Contract . . . between the Filer and a client."

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significant of these understandings is the introduction of the concept of crypto contracts. If the crypto contract constitutes a legitimate description of the relationship between CTPs and their users,[56] tax policy makers and administrators will need to re-examine how Canadian-resident CTP users are taxed. In particular, this article suggests that the taxation of crypto contracts as crypto contracts, rather than as crypto assets, could potentially result in (1) the need for a different method to determine whether CTP users' transactions are undertaken on income or capital account, and (2) CTP users being able to elect to have their transactions taxed on capital account. The income taxation of crypto contracts may also involve struggles to accommodate novel forms of payment (such as staking rewards earned through CTPs) and the application of various provisions of the Act (such as section 49.1). In any case, these new understandings require further thought from Canadian tax professionals. Canada's income tax policy makers and administrators cannot afford to let another decade pass while blockchain technologies continue to innovate at breakneck speed.

56 But see supra notes 8 and 15 for arguments to the contrary.

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