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A Guide to Bitcoins and Income Taxes

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When determining the personal income tax consequences of Bitcoins and similar digital currencies, there are two important questions:

Guide inspired by Canada's Bitcoin community at coinforum.ca.

1. How Did You Acquire the Bitcoins or Similar Digital Currencies?

Mining Bitcoins or Similar Digital Currencies

The tax consequences from mining Bitcoins or similar digital currencies depends on whether the Canada Revenue Agency ("CRA") considers the mining operations to constitute carrying on a business or whether the mining is a personal endeavour or hobby. The CRA will consider all the facts and circumstances of each situation so there is no definitive test or criteria because each individual's situation is unique.

The CRA may consider a person to be running a business if the person has the subjective intention to profit and there is evidence of businesslike behaviour which supports that intention. At the moment, the CRA has not released the specifics on how and when the revenues from mining businesses will be taxed. The Internal Revenue Service in the US currently taxes miners on the value of the mined Bitcoins or similar digital currencies when received. It would not be a stretch to think the CRA may follow the same approach. Regardless, individuals involved in the business of mining Bitcoins or similar digital currencies would report the details of their business on Form T2125, Statement of Business or Professional Activities.

A personal endeavour or hobby is an activity primarily undertaken for pleasure, entertainment, or enjoyment rather than for profit, business, or commercial reasons. The receipt of the mined Bitcoins or similar digital currencies from a personal endeavour or hobby would not be taxable as income when received but would be taxable when disposed. That being said, it may be a very difficult argument to substantiate that mining for Bitcoins or similar digital currencies was undertaken as a hobby since something of value was ultimately received for the efforts.

Purchasing Bitcoins or Similar Digital Currencies

There are no immediate tax consequences from just the purchase of Bitcoins or similar digital currencies.

Receiving Bitcoins or Similar Digital Currencies for Goods or Services

When receiving Bitcoins or similar digital currencies in exchange for goods or services, the barter transaction rules will apply.

Businesses that provides services or goods in exchange for Bitcoins or similar digital currencies will be deemed to have received what the business would have normally charged for the goods or services. If this information isn't available, the CRA will generally accept the value of the Bitcoins or similar digital currencies as the price of the goods or services sold, assuming that the transaction took place under normal business circumstances.

For example, a blog business that receives ad revenues in the form of Bitcoins will be deemed to have earned what they would normally charge for ad placements on the blog.

Note that there may be GST/HST considerations if the business engages in barter transactions.

2. What Are Your Intentions with the Bitcoins or Similar Digital Currencies?

Determining whether the Bitcoins or similar digital currencies are held as inventory or investments depends on the specific facts of each situation. Factors the CRA may consider are the frequency of transactions, period of ownership, knowledge of the securities markets, and time spent.

There are no definitive thresholds or tests that would automatically determine how the Bitcoins or similar digital currencies are being held because each individual's situation is unique. For instance, individual A may recognize a capital gain on the sale of a Bitcoin, but individual B would recognize the same gain on account of income because individual B has more knowledge about the securities market and has held the Bitcoin for a much shorter period of time.

Holding the Bitcoins or Similar Digital Currencies as Investments

The gain or loss on the Bitcoin or similar digital currencies held as investments and on account of capital is only reported when they have been disposed, usually through a sale or exchange of the Bitcoin or similar digital currency. Only half the resulting gain or loss is included into income as a taxable capital gain or an allowable capital loss, respectively.

For example, let's say an individual purchases a fraction of a Bitcoin at $500 in Year 1. The price of that fraction subsequently rises to $1,000 in Year 2 and drops to $800 Year 3. The individual finally sells the fraction at $900 in Year 4. The individual would report proceeds of $900, cost of $500 and a gain of $400 in Schedule 3, Summary of Dispositions – Capital Gains or Losses. The resulting $200 taxable capital gain (i.e. ½ of $400) would be included in the individual's Year 4 tax return and would be subject to tax.

Holding the Bitcoins or Similar Digital Currencies as Inventory

Bitcoins or similar digital currencies are generally considered to be held as inventory and on account of income when the course of conduct in trading or selling Bitcoins or similar digital currencies resembles a business. When held as inventory in a business, the inventory valuation method to account for the Bitcoins or similar digital currencies may have potential revenue consequences each year.

The gain or loss on the Bitcoin or similar digital currencies when disposed of, usually through a sale or exchange of the Bitcoin or similar digital currency, is treated as ordinary income and fully taxable. The trading business information including any reasonable expenses in operating that business would be reported on Form T2125.

Special Items

Exchanging Digital Currencies

When one type of digital currency is exchanged for another type of digital currency, the exchange is considered a disposition for tax purposes and the barter transaction rules apply. For example, in a situation where an individual exchanges their Bitcoin for Ethereum, the individual would need to report the disposal of the Bitcoin on their tax return in the year the exchange happens. Only the digital currency that is exchanged is considered disposed of and subject to the barter transaction rules. In the example above, the cost of the exchanged Bitcoin is the average cost of each Bitcoin owned by the individual multiplied by the amount of Bitcoin exchanged.

Valuing Digital Currency Transactions

When determining the proceeds and cost of a digital currency, it is best to use the price at which the purchase or sale has been settled at or the value of the digital currency at the time the transaction is executed. An average price may not be sufficiently accurate considering the volatility of digital currency prices unless it is the most readily available information.

Next Steps

The tax rules for Bitcoins and similar digital currencies are constantly developing and its huge spike in popularity has certainly attracted the attention of the tax authorities. It is important that taxpayers stay updated about the latest developments. If you would like specific tax advice regarding your situation, please contact one of our tax professionals at Crowe Soberman to assist you.

Connect with the Author

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