Speculators Get Relief from Crypto Losses

2022 was not a good year for investors. Stocks and bonds tumbled, and bitcoin crumbled. The S&P/TSX composite index was down 8.7%; the S&P 500 lost 19.4%; NASDAQ composite lost 33.1%; the Dow Jones Industrial Average lost 8.8%. Bitcoin, the world's largest digital coin fell more than 60%. However, the good news is that Canada will share some investor losses. Since disputes with the Canada Revenue Agency have a prolonged life, investors should save their transactional documents, transactional evidence, and be patient.

The gurus are predicting that markets will increase or decrease in 2023. They are right. However, the immediate question for investors is how to report crypto related losses in April for tax purposes. The answer depends upon their intention when they acquired their crypto assets, the origin of their funds, and how they declared previous gains or losses. In the right circumstances, Canada will relieve the pain of investors and share some of their losses.

FTX's attorneys, for example, have admitted in U.S. bankruptcy court that a 'substantial amount' of the firm's assets were stolen or missing, and that the 50 largest creditors alone are owed more than $3 billion.

The quintessential characteristic of the Canadian tax system is that it taxes each sources of income according to different rules and rates. A "buck is not a buck". Whereas we fully tax business income, only one-half of capital gains are taxable. Similarly, whereas business losses are generally fully deductible from other sources of income, capital losses are usually only one-half deductible, and then only against taxable capital gains.

For example, if Jane, who has a 50 percent marginal tax rate, earns $100 business income, she would be liable for $50 tax, whereas she would pay only $25 if the income is a capital gain (50% x $50). If she suffers a business loss of an equivalent amount, she can apply $50 of the loss against any other source, such as employment income. In contrast if the loss is a capital loss, she can deduct only $25, and only against other taxable capital gains. Hence, the ultimate tax for individuals who purchase stocks, bonds, and crypto assets depends upon the legal distinction between the two, business income (loss) and capital gains (losses). Canadian investors in the FTX exchange may be eligible for partial tax relief for their losses.

So how do we distinguish between the two sources? The distinction is deceptively simple. Income derives from trading or the periodic yield of an investment. Capital gains stem from a sale or realization of the investment. The key is in identifying whether the investor intended to "trade" the asset or sell an investment. The distinction depends upon the taxpayer's intention.

An "investment" is property that one acquires with the *intention* of holding or using *to produce* income. Thus, an investment is a means to an end. Where a taxpayer acquires property with an intention to "trade", any gain or loss from the trade is business income (loss).

One determines the taxpayer's intention based on objective evidence when he acquires the asset. The taxpayer's conduct, rather than *ex post facto* declarations, provides the key to intention.

Hence, the investor's intention in acquiring crypto related assets will determine the treatment of subsequent gains or losses. Did Jane acquire the property intending to trade or speculate on its future value or did she acquire it as an investment asset? Speculative losses would be fully deductible against their other income, which would provide 50% relief. The government would, in effect, share the loss with the taxpayer.

The CRA does not like taxpayers reducing their tax bill and will enthusiastically pounce on those who claim business losses. They will want to know the source of funds used to purchase assets, and past tax reporting behaviour. Since tax disputes typically take years to litigate, investors should fully document their transactions and store their supporting evidence. Tax disputes can easily extend to 8 – 10 years to resolve, during which time the CRA will levy interest on the disputed amount based on a daily compounded rate. Taxpayers who fight with government must be patient.

Professor Vern Krishna, CM, KC, FRSC (University of Ottawa Law School)

Of Counsel: TaxChambers LLP (Toronto)