Blockchain & Cryptocurrency Regulation

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Canada

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Government attitude and definition

The general attitude of the Canadian government (including regulatory agencies) to cryptocurrencies has been a mix of caution and encouragement: caution in terms of protecting investors and the public, but encouragement in its support of new technology. For example, as early as 2015, the Standing Senate Committee on Banking, Trade and Commerce produced a report entitled, "Digital Currency: You Can't Flip This Coin", in which the committee stated:

> *…the Committee strongly believes that a balanced regulatory approach is needed in the digital currency sector. On one hand, the Committee is mindful that the government has the responsibility to protect consumers and root out illegal activity. On the other hand, it is critical that government action does not stifle innovation in digital currencies and its associated technologies that are in an early and delicate stage of development.*
>
> *Having completed the study, the Committee is of the opinion that the opportunities presented by digital currencies, technologies and businesses outweigh the challenges. The Committee is confident that the implementation of our recommendations will have positive outcomes for consumers, merchants, digital currency-related businesses, Canada's financial services sector and others. The Committee looks forward to timely government action designed to maximise the opportunities and manage the challenges facing the digital currency sector.*

The Canadian government itself is also experimenting with blockchain technology. The National Research Council is testing blockchain to publish research grant and funding information in real time.[1]

For taxation purposes, cryptocurrencies are treated as commodities, not as money. Under securities laws, many cryptocurrencies or "tokens" are classified as securities.

Cryptocurrencies are not treated as legal tender in Canada. According to section 8 of the *Currency Act*, legal tender is coins issued by the Royal Canadian Mint under the *Royal Canadian Mint Act*, and notes issued by the Bank of Canada under the *Bank of Canada Act*.[2]

Despite cryptocurrency not being recognised as legal tender, the Bank of Canada tested Digital Depository Receipts (DDR) as a digital representation of Canadian currency in 2016 and 2017. DDR is a way to transfer central bank money on to a distributed ledger technology platform (DLT, or "blockchain"). DDRs are issued as digital tokens on a blockchain and act as a claim on central bank reserves.[3] This was tested in Project Jasper in the form of "CADcoin" where the Bank of Canada issued DDR, just like it would Canadian currency,[4]

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"in order to better understand the potential impacts of blockchain technology on Financial Market Infrastructure" ("**FMI**").[5]

Project Jasper was a joint initiative between the public and private sector, conducted by the Bank of Canada and Payments Canada with the help of banks and corporations (such as R3). Together, they built and tested a closed, simulated payment system to better understand the potential for blockchain to augment or displace FMI. Project Jasper marked the first ever DLT experiment in which a central bank partnered with private financial institutions.[6]

There were two phases of the project. Phase One was developed on an Ethereum platform. Ethereum uses Proof-of-Work ("**PoW**") consensus protocol to operationally settle transactions. Phase Two was built on the Corda platform. In this test, the Bank of Canada served as a notary, accessing the entire ledger and verifying the transactions.[7]

The Bank of Canada also considered legal settlement finality. Project Jasper was designed so that a transfer of DDR equalled a full and irrevocable transfer of the underlying claim on central bank deposits.[8] While using DDR requires significant Bank of Canada involvement in a system that many hope will be decentralised, it can provide certainty regarding legal settlement finality rarely found in blockchains.

Cryptocurrency regulation

In Canada, cryptocurrencies are primarily regulated under securities laws as part of the securities' regulators mandate to protect the public.

Sales regulation

In Canada, securities laws are enacted on a provincial and territorial basis rather than federally. The securities rules throughout the provinces and territories have largely been harmonised. The Canadian Securities Administrators (the "**CSA**"), an unofficial organisation, represents all provincially and territorially mandated securities regulators in Canada.

Defining a "security"

The securities laws of a province or territory apply to people and entities: (a) distributing securities in that jurisdiction; or (b) from that jurisdiction. "Security" is broadly defined in Canadian securities legislation and covers various categories of transactions, including "an investment contract".[9] The test for determining whether a transaction constitutes an investment contract, and therefore a security, for the purposes of Canadian securities laws was established by the Supreme Court of Canada, referring to United States jurisprudence.[10] This test, the "**Investment Contract Test**", requires that in order for an instrument to be classified as a security, each of the following four elements must be satisfied:

1. there must be an investment of money;
2. with an intention or expectation of profit;
3. in a common enterprise (being an enterprise "in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment, or of third parties"[11]); and
4. the success or failure of which is significantly affected by the efforts of those other than the investor.

The application of the Investment Contract Test has been the subject of judicial and regulatory consideration that is beyond the scope of this overview. That being said, where the elements of the Investment Contract Test are not strictly satisfied, securities regulators

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in Canada are mandated to consider the policy objectives and the purpose of the securities legislation (namely, the protection of the investing public by requiring full and fair disclosure) in making a final determination. This acts a little like a legislative "basket clause". The Supreme Court of Canada has stated that substance, not form, is the governing factor in determining whether a contract (or group of transactions) is an investment contract.[12]

Regulator guidance

In addition to the law in Canada as set out in the Investment Contract Test, certain securities regulators in Canada have issued notices and statements regarding the potential application of securities laws to cryptocurrency offerings ("**ICOs**"). These notices and statements confirm that Canadian securities regulators, while receptive to innovation and development, continue to carefully monitor investment activity in this space.

In March 2017, the Ontario Securities Commission issued a press release[13] warning that ICOs may trigger certain Ontario securities law requirements (including registration or prospectus requirements), even if the coins or tokens do not represent shares or equity in an entity.

In August 2017, the CSA issued Staff Notice 46-307 *Cryptocurrency Offerings* ("**SN 46-307**").[14] Currently, this is the most comprehensive guidance regarding the applicability of existing securities laws to cryptocurrency offerings in Canada. In SN 46-307, the CSA stated that it was aware of businesses marketing their coins or tokens as software products, and taking the position that the offerings are exempt from securities laws, but cautioned that "in many cases, when the totality of the offering or arrangement is considered, the coins/tokens should properly be considered securities", including because they are investment contracts.[15] In line with Canadian jurisprudence and the Investment Contract Test, the CSA affirmed that it will consider substance over form in assessing whether or not securities laws apply to an ICO.

The CSA further cautioned that, depending on the facts and circumstances, coins or tokens may be considered derivatives and subject to applicable legislative and regulatory requirements.

In June 2018, the CSA issued Staff Notice 46-308 *Securities Law Implications for Offerings of Tokens* ("**SN 46-308**").[16] In SN 46-308, the CSA generally reiterated the position it took in 46-307. Importantly, it again confirms that an ICO may involve a distribution of securities not covered by the non-exclusive list of enumerated categories of securities in the OSA if the offering otherwise falls within the policy objectives and purpose of securities legislation. In addition, the CSA indicated that it had found that most offerings of tokens purporting to be utility tokens involved the distribution of a security, and specifically an investment contract.

Securities law requirements

In Canada, absent an available exemption, a prospectus must be filed and approved with the relevant regulator before a person or entity can legally distribute securities. A prospectus is a comprehensive disclosure document which seeks to satisfy the public protection aim of securities laws by disclosing information about the securities and the issuer to prospective investors. Exemptions from the prospectus requirement are principally set out in National Instrument 45-106 – *Prospectus Exemptions* ("**NI 45-106**"). Generally, securities sold pursuant to a prospectus exemption are subject to resale restrictions and, particularly in the case of a non-reporting issuer (i.e. an issuer that is not a public entity and is not subject to ongoing securities compliance and disclosure obligations), may never be freely tradeable. Resale restrictions rules are set out in National Instrument 45-102 – *Resale of Securities* ("**NI 45-102**").

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In addition to the prospectus requirement, an individual or entity engaged in the business of distribution of securities, or advising others with respect to securities, is required to register with Canadian securities regulators. The requirements for registration, and exemptions from registration, are set out in National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**"). Once registered, the person or entity is subject to various reporting and compliance obligations. NI 31-103 covers various other categories of registration in addition to dealers and advisers, such as investment fund managers.

Legal status of ICOs in Canada

The present Canadian regulatory trend is to apply and adapt existing securities laws, including the Investment Contract Test, to transactions involving blockchain or cryptocurrency which resemble traditional securities, without regard to the use of new technology.[17] In order to make a determination on whether or not an ICO constitutes a distribution of securities, Canadian securities regulators will perform a case-by-case, highly fact-dependent analysis, focusing on the substance and structure of the ICO rather than its form.[18] Even if an ICO cannot be said to fall within the specific definition of a "security" provided by legislation, as discussed above, it may nonetheless be found to involve the sale of securities if it otherwise triggers the policy objectives and purposes of securities legislation.

Applying the investment contract test to ICOs

As discussed above, there is presently no caselaw or legislation in Canada definitively addressing when an ICO or other sale of cryptocurrency will constitute a distribution of securities. However, statements from the CSA offer guidance regarding certain elements of an ICO that may increase the likelihood of the coins or tokens being found to be securities.[19] While each offering of coins or tokens should be analysed based on the particular circumstances of the offering and the features of the coin or token, these statements, together with statements by United States securities regulators on the subject,[20] offer insight into how the Investment Contract Test may be applied to ICOs.

Coins or tokens as securities

If an ICO is found to constitute a distribution of securities, it will trigger Canadian securities law requirements, including prospectus and registration requirements, unless an exemption from the same is available. Individuals or businesses intending to rely on prospectus exemptions in connection with an ICO will need to ensure that they satisfy the conditions for such exemption as set out in NI 45-106, including any applicable resale restrictions in NI 45-102. Resale restrictions will be of particular concern if coins or tokens begin trading on cryptocurrency exchanges or otherwise in the secondary market following their initial sale. Issuers of a cryptocurrency that is found to be a security will also need to ensure that they comply with any applicable registration requirements, including dealer registration, or that the conditions for an exemption from registration are fully satisfied. Failure to comply with securities laws may result in regulatory or enforcement action by securities regulators against the parties behind the ICO, including fines and potential incarceration.

Taxation

Characterisation of cryptocurrency for tax purposes

The Canadian tax authorities currently adopt the position that, despite its nomenclature, a cryptocurrency is not a "currency" for income tax purposes. Rather, cryptocurrency is akin to a commodity (albeit an "intangible"), the value of which will fluctuate based on

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external factors driven largely by investor sentiment and basic supply/demand. In this respect, cryptocurrency could be analogised as the virtual equivalent of a precious metal such as gold or silver.

Accordingly, the acquisition of, and transacting in, cryptocurrencies is generally regarded as the acquisition of, and transacting in, commodities. This characterisation has significantly different tax implications under Canadian tax law as compared to "normal" cash (even foreign currency) transactions.

(a) *Acquisition of cryptocurrency*

The threshold question is whether the initial acquisition of a cryptocurrency is a taxable event that potentially triggers a Canadian income tax liability to the person acquiring the cryptocurrency. The answer depends on the manner, purpose and circumstances in which the cryptocurrency is acquired.

If the cryptocurrency is acquired through "mining" activities of a commercial nature (*i.e.*, mining carried out generally for business purposes or in connection with a business), the current published administrative position of the Canadian tax authorities is that the acquirer will be required to report business income for the year determined with reference to the value of the mined cryptocurrency. For this purpose, the mined cryptocurrency will generally be treated as inventory of the business. Such a holder will have a myriad of tax issues distinct from the acquisition of cryptocurrency from non-mining activities, and must be reviewed on a case-by-case basis.

The acquisition of cryptocurrency as a pure speculative investment, similar to physical gold or a publicly-traded security, is generally not a taxable event to the person acquiring the cryptocurrency. However, the acquisition will establish the holder's "cost" in the cryptocurrency for Canadian tax purposes, which is relevant in the determination of the tax consequences that will be realised later when the cryptocurrency is eventually sold or otherwise exchanged.

This is to be contrasted with the acquisition of cryptocurrency as consideration for the provision of goods or services, or as compensation for some other right of payment. Such transactions are generally governed at this time by the Canadian tax authorities' position regarding "barter transactions", which is described in greater detail below under the heading "*Using cryptocurrencies in business transactions – Barter transaction*".

(b) *Determining a holder's tax cost in cryptocurrency*

Once a cryptocurrency has been acquired, it will be important to determine its cost for Canadian tax purposes, which is a fundamental concept for determining the future income tax consequences on an eventual disposition of the cryptocurrency.

Where a cryptocurrency is purchased in exchange for Canadian currency, the cost of the cryptocurrency for income tax purposes will be equal to the amount of cash paid, plus any directly related acquisition expenses. If foreign currency is used, the holder will generally be required to convert the foreign currency into the Canadian-dollar equivalent at the applicable rate, pursuant to Canadian tax rules.

Cryptocurrencies can obviously be acquired by several alternative means, including commercial business transactions and other forms of "barter" exchanges. The particular facts surrounding any such acquisition could have meaningful distinctions regarding the determination of the holder's tax cost upon the acquisition of the cryptocurrency (see below, under the heading "*Using cryptocurrencies in business transactions – Barter transaction*").

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(c) *Tax on disposition of cryptocurrency*

A person will realise taxable income (or loss) on an eventual disposition of a cryptocurrency. This includes a sale of the cryptocurrency for cash and the use of the cryptocurrency to pay for goods or services, or as consideration under other contractual rights/obligations (*i.e.,* a "barter transaction", described below).

If the cryptocurrency has a value at the time of its disposition in excess of its tax cost, it will be critical to determine whether the holder should report such excess as being on capital account (*i.e.*, a capital gain) or whether the proceeds should be reported as business income. This is a material distinction for tax purposes.

Generally, the buying and selling of a commodity can be regarded as being on capital account unless it is carried out in the context of a business of buying and selling such commodities, or such buying and selling otherwise amounts to an "adventure or concern in the nature of trade". This is a factual, case-by-case determination requiring a detailed review of the holder's dealings with such commodities.

If a person acquires cryptocurrency as payment for goods or services in the normal course of the person's business (even if the person is not, *per se*, in the business of buying and selling cryptocurrencies as part of a speculative investment business), there is a risk that any appreciation realised when the person disposes of the cryptocurrency will be fully taxable as business income. Again, this issue is fact-dependent, should be reviewed on a case-by-case basis, and is described in greater detail below.

Using cryptocurrencies in business transactions

(a) *Barter transaction*

A person can accept a commodity in exchange for the provision of a good or service or as consideration for some other form of right of payment, with such transaction being subject to tax treatment under Canada's "barter transaction" tax rules.

In a barter transaction using cryptocurrency, the following must be considered by the person (referred to below as the "provider") that accepts a cryptocurrency as consideration in exchange for a good, service or other right:

- The provider will generally realise business income for Canadian income tax purposes equal to the fair market value of the goods, services or other rights provided (the "**Business Income Inclusion**"). For this purpose (but not for other purposes – see, *e.g.*, the sales tax implications described below), the value of the cryptocurrency at the time of the exchange is generally not the determining factor.
- The provider will generally acquire the cryptocurrency with a cost for Canadian income tax purposes equal to the Business Income Inclusion.
- The provider is now the owner of the cryptocurrency and must (eventually) do something with it, such as sell it to an investor or use it to purchase goods/services/rights in connection with its own business. Any gain or loss realised by the provider on an eventual disposition of the cryptocurrency (*i.e.*, the difference between the provider's cost in the cryptocurrency, and the amount received on the eventual disposition) will be taxable at such time to the provider. The issue then becomes whether such gain/loss is treated as being on full income account or on account of capital (the income tax treatment being materially different as between the two) (see the discussion above under the heading "*Characterisation of cryptocurrency for tax purposes – Determining a holder's tax cost in*

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cryptocurrency"). Managing the provider's exposure to fluctuations in the value of the cryptocurrency post-acquisition will be a material and practical concern.

Another type of increasingly prevalent transaction (which may or may not be properly characterised as a "business transaction") is the acquisition by a person of one cryptocurrency ("crypto #1") in exchange for a different cryptocurrency ("crypto #2"). Such a transaction will also be considered a barter transaction involving the exchange of one commodity for another commodity. The person will generally be considered to have acquired crypto #1 with a tax cost equal to the fair market value of the crypto #2 given up in exchange, computed as of the time of the barter transaction. The additional complication in this scenario is that the person acquiring crypto #1 will also be considered to have disposed of crypto #2, and will have to report any income/gain in respect of crypto #2 for Canadian income tax purposes (the person must therefore know his/her tax cost in crypto #2, which depends on the manner in which crypto #2 was originally acquired by such person).

(b) *Sales tax implications*

Canada imposes a federal sales tax (the goods and services tax, or "**GST**") on the supply of many goods and services, subject to detailed exemptions. Most Canadian provinces and territories also levy sales tax, which is often "harmonised" with the federal sales tax to effectively create one blended federal/provincial (or territorial) rate. Persons that are required to charge and collect federal GST (or harmonised sales tax) in respect of a business activity can generally claim a rebate in respect of such tax that the person directly incurs in the course of carrying on such business (generally referred to as an input tax credit or "**ITC**"). The ITC mechanism is generally intended to mitigate the duplication of sales tax throughout a supply chain, and is designed to ensure that the cost of sales tax is ultimately borne solely by the end consumer of any particular good or service.

As with any provision of goods or services subject to federal and provincial/territorial sales taxes, a provider of goods/services that accepts cryptocurrency in lieu of government-issued currency must charge, collect and remit the appropriate sales tax. This may prove easier said than done in the context of cryptocurrency.

In this respect, the provider must be careful not to use the Business Income Inclusion amount (which is relevant under the Canadian tax authorities' current administrative policy to determine the provider's income tax associated with the sale) in determining the applicable amount of sales tax. For federal GST purposes, the Canadian tax authorities require that the provider charge, collect and remit GST based on the value of the cryptocurrency at the time of the sale. Presumably, the purchaser would be entitled to claim an input tax credit (if available) in respect of the full GST charged, if incurred in the course of a business activity.

While this may sound manageable at a high level, a few practical issues arise for the provider:

- How does the provider determine the value of the cryptocurrency at the precise moment of sale, particularly when cryptocurrencies are traded in non-traditional marketplaces and the value can swing wildly from day to day (possibly minute-by-minute)? What record-keeping is required by the service provider to justify the amount upon which it charges sales tax?
- How does the provider charge, collect and remit the sales tax in a transaction

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entirely handled in cryptocurrency, namely where the sales tax portion is also paid in cryptocurrency? The provider must remit to the Canadian tax authorities in Canadian currency (not cryptocurrency), meaning that the provider will be forced to either remit an equivalent amount of cash from other sources, or sell a sufficient amount of the cryptocurrency to generate the cash to satisfy the remittance. Given the volatility of most cryptocurrencies, an inherent risk is borne by the provider in collecting the sales tax in cryptocurrency.

- Corporate directors are personally liable for any deficiencies in collecting or remitting sales tax. It is therefore critical for the provider of goods/services to take reasonable measures to ensure full compliance and mitigate any associated risk.

Money transmission laws and anti-money laundering requirements

Canada was the first country to approve regulation of cryptocurrencies in the context of anti-money laundering. In 2014, the Parliament of Canada passed Bill C-31. This bill amends Canada's *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* to include digital currencies. The bill laid out a framework for regulating entities "dealing in digital currencies", treating them as money services businesses ("**MSBs**"). As MSBs, those dealing in digital currencies are subject to the same record keeping, verification procedures, suspicious transaction reporting and registration requirements as MSBs dealing in fiat currencies.[21] As of July 2018, the amendments resulting from Bill C-31 had not been proclaimed in force.

Promotion and testing

The CSA Regulatory Sandbox was set up to encourage the development of innovative products and services. The Sandbox allows companies engaged in cryptocurrency matters to register or seek exemptive relief (generally on a time-limited basis) in order to test products and services in the Canadian market.

Ownership and licensing requirements

As noted above, an individual or entity engaged in the business of distribution of securities, or advising others with respect to securities, may be required to register with Canadian securities regulators. Similarly, investment fund managers are required to be registered.

On December 11, 2017 the Investment Industry Regulatory Organization of Canada ("**IIROC**"), the organisation that governs persons and companies registered under securities law, issued a notice to its members regarding margin requirements for cryptocurrency futures contracts that trade on commodity futures exchanges. According to the notice, members are required to market and margin crypto futures contracts daily at the greatest of: (a) 50% of market value of the contracts; (b) the margin required by the futures exchange on which the contracts are entered into; (c) the margin required by the futures exchange's clearing corporation; and (d) the margin required by the Dealer Member's clearing broker.

Mining

Because mining converts electrical energy (typically drawn from the power grid or a private power source) into waste heat in proportion to the difficulty of the underlying mathematical problem, it can result in large quantities of power being used for what may be perceived as a socially undesirable purpose. Furthermore, because mining enables

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the operation of a variety of cryptocurrencies (e.g. Bitcoin), it functions as a convenient point for regulatory intervention. For those reasons, many official bodies have started to explore, or in some cases implemented, laws or policies that contemplate cryptocurrency mining. In Canada, governmental regulators appear to have adopted a largely "hands-off" approach for the time being.

However, Hydro Quebec (a Quebec Crown entity) recently announced the implementation of higher power prices for users involved in cryptocurrency mining, the effect of which may be to discourage such activities in that Province. We expect to see further intervention by government actors, as the quantity of power used by cryptocurrency mining operations, along with the use of various cryptocurrencies to facilitate illegal activities, continues to grow. To counteract the deleterious effects of such regulations on their operations, we additionally expect to see bitcoin miners move to private power sources as time goes on.

Border restrictions and declaration

There are no border restrictions or declaration requirements as such.

Reporting requirements

See "*Money transmission laws and anti-money laundering requirements*", above. MSBs are required to send a large cash transaction report to the Financial Transactions and Reports Analysis Centre of Canada ("**FINTRAC**") upon receipt of an amount of $10,000 or more in cash in the course of a single transaction, or receipt of two or more cash amounts of less than $10,000 each that total $10,000 or more, if the transactions were made by the same individual or entity within 24 hours of each other.

Estate planning and testamentary succession

Canada levies no separate estate tax, unlike many countries. However, a deceased is deemed to dispose of their property on death for its fair market value, which can result in income taxes being payable by the estate. Although it is far from settled, the Canada Revenue Agency currently takes the view that cryptocurrencies are generally commodities rather than currency, and that trading in cryptocurrencies will usually (with some possible exceptions) be regarded as being on capital account. In such circumstances, the estate will have to pay tax on any capital gains accrued as of the date of death. For a more detailed discussion of tax issues, see "Taxation" above.

In terms of estate planning, given the anonymous, decentralised nature of cryptocurrencies held on a blockchain, it will be imperative to include instructions on where to locate a copy of the private key related to the cryptocurrency. It would be unwise to include a private key in the will itself, since wills generally become public documents following probate.

* * *

Endnotes

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10. *Pacific Coast Coin Exchange v Ontario Securities Commission*, [1978] 2 SCR 112 [*Pacific Coast*].
11. *Ibid.* at p. 129, quoting *SEC v. Glen W. Turner Enterprises, Inc.*, 474 F. 2d 476 (1973) at p.482.
12. Pacific Coin para 43. A flexible approach to defining an investment contract has also been promoted by the Ontario Securities Commission in *Bluestream Capital Corp, Re* (2015), 38 OSCB 2333.
13. See Ontario Securities Commission, News Release, "OSC Highlights Potential Securities Law Requirements for Businesses Using Distributed Ledger Technologies" at http://www.osc.gov.on.ca/en/NewsEvents_nr_20170308_osc-highlights-potential-securities-law-requirements.htm.
14. See Canadian Securities Administrators, Staff Notice 46-307 *Cryptocurrency Offerings* at http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20170824_cryptocurrency-offerings.htm.
15. See SN 46-307 at 3.
16. See Canadian Securities Administrators, Staff Notice 46-308 *Securities Law Implications for Offerings of Tokens* at http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20180611_46-308_securities-law-implications-for-offerings-of-tokens.htm.
17. SN 46-307, p.3.
18. *Ibid*.
19. See SN 46-307 and Canadian Securities Administrators, Staff Notice 46-308 *Securities Law Implications for Offerings of Tokens* [SN 46-308].
20. See United Stated Securities and Exchange Commission, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, SEC Release No 81207 (July 25, 2017).
21. https://research.osc.gov.on.ca/c.php?g=699050&p=4969862.

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