LAW360™ Canada

Law360 Canada | 111 Gordon Baker Road, Suite 900 | Toronto, ON M2H 3R1 | www.law360.ca

Tax

Proposed amendments to GST/HST rules for cryptocurrency mining, part two

By **David J. Rotfleisch**

David Rotfleisch

(February 22, 2023, 8:43 AM EST) -- The proposed cryptocurrency-mining tax rules contain an exception when a person performs the cryptocurrency-mining activity for another person whose identity is known to the first person and who doesn't qualify as a "mining group operator" — in other words, a co-ordinator of a mining pool.

In these limited circumstances — when someone mines cryptocurrency for a known person who doesn't co-ordinate a mining pool — s. 188.2 of the *Excise Tax Act* doesn't apply, and the cryptocurrency miner may need to charge GST/HST on that mining income and will claim input tax credits (ITCs).

The key definition under the proposed s. 188.2 is that of a "mining activity." A "mining activity" is deemed to not be a supply for GST/HST purposes.

The definition of "mining activity" seems to clearly contemplate the mainstream understanding of what constitutes cryptocurrency mining — namely, the verification process in blockchain protocols that rely on the proof-of-work validation mechanism.

Under the proof-of-work system, the validator — i.e., the cryptocurrency miner — devotes computing power toward solving mathematical problems. By doing so, the miner verifies new cryptocurrency transactions and shares the results with other network participants by recording the verified transaction as a new block on the blockchain.

An open question is whether "mining activity" also intends to capture the verification process in blockchain protocols that rely on the proof-of-stake validation mechanism known as "staking" or "forging." The proof-of-stake system assigns validation rights to users in accordance with their stake in the blockchain. The draft legislation doesn't use the words "staking" or "forging" or distinguish between proof-of-work validation mechanisms and proof-of-stake systems.

The proposed legislation presumably aims to capture cryptocurrency activities relating to blockchain-transaction verification, regardless of which verification process the blockchain protocol invokes. On the other hand, unlike cryptocurrency mining, cryptocurrency staking exhibits characteristics of an investment.

Unlike a cryptocurrency miner, who can receive a mining reward without having previously owned any of the blockchain's native tokens, the cryptocurrency staker cannot earn staking rewards without making a prerequisite investment in the cryptocurrency platform's native tokens. Perhaps this distinction justifies some differential GST/HST treatment.

In any event, since the Department of Finance has yet to clarify this, it remains unclear whether the proposed s. 188.2 applies to cryptocurrency staking.

It is, however, clear that the proposed s. 188.2 doesn't apply to liquidity mining. Unlike cryptocurrency mining (i.e., the verification process in the proof-of-work system), liquidity mining has nothing to do with verifying transactions on the blockchain network.

Rather, it generally constitutes a DeFi (decentralized finance) loan or investment. In cryptocurrency liquidity mining (also called "yield farming"), an investor lends or contributes capital to a cryptocurrency platform — typically, a startup cryptocurrency platform seeking to raise capital.

The investor receives some or all interest payments, a share of the cryptocurrency platform's transaction fees, or a specialized token giving the investor the right to redeem that token for a certain number of cryptocurrency units. Because the proposed s. 188.2 doesn't apply to liquidity mining, certain liquidity-mining arrangements might draw GST/HST liability.

Finally, the proposed s. 188.2 doesn't apply to the creation or sale of non-fungible tokens, or NFTs.

This is part two of a two-part series. Part one: Proposed amendments to GST/HST rules for cryptocurrency mining.

David J. Rotfleisch *is the founding tax lawyer of* Rotfleisch & Samulovitch P.C.*, a Toronto-based boutique tax law and corporate law firm. He appears regularly in print, radio and TV. With over 35 years of experience as both a tax lawyer and chartered professional accountant, he has helped startup businesses, resident and non-resident business owners and corporations and cryptocurrency traders with their tax planning, with will and estate planning, voluntary disclosures and tax dispute resolution including tax audit representation and tax litigation.*

The opinions expressed are those of the author and do not reflect the views of the author's firm, its clients, Law360 Canada, LexisNexis Canada, or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

Photo credit / ojogabonitoo ISTOCKPHOTO.COM

Interested in writing for us? To learn more about how you can add your voice to Law360 Canada, contact Analysis Editor Yvette Trancoso at Yvette.Trancoso-barrett@lexisnexis.ca *or call 905-415-5811.*