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Bitcoin – Subject to Capital Gains Tax

In a landmark ruling, the Israeli Tax Court classified cryptocurrency as an “asset” and rejected the taxpayer classification of Bitcoin as a currency or a security.

The District Court held in the matter of **Noam Koppel v. Rehovot Tax Assessor** that Bitcoin is an asset, not a currency or a security, for the purposes of the Income Tax Ordinance (the “**ITO**”), and accordingly ruled that its sale is subject to capital gains tax.

The ruling revolves around the classification of Bitcoin – a digital unit registered and managed using distributed ledger technology based on *blockchain technology* – for tax purposes and the taxation of profits arising from the realization of the appreciation in its value.

Under the ITO, an increase in a currency’s value derived of exchange rate differentials, and an increase in the value of a security as a result of linkage differentials, may be exempt.

In Koppel, the Appellant argued that the sale of Bitcoin is exempt from taxes because it is a “*Foreign Currency*” in which profits are exchange rate differentials that are not received as part of a business, and therefore are exempt under the ITO. Furthermore, the Appellant challenged the definition of “*Foreign Currency*” in the Israeli legislation calling it outdated and incapable of capturing modern technology. Alternatively, the Appellant argued that Bitcoin is a security linked to its exchange rate. Therefore, any increase in the security’s exchange rate of Bitcoin is exempt under the ITO. Conversely, the Tax Assessor argued that Bitcoin is not a currency but rather an asset as defined in the ITO. As such, the profits become taxable under the Israeli capital gains regime.

Justice Bornstein, adopted the Tax Assessor's construction and ruled that Bitcoin is an asset.

In his opinion, Judge Bornstein noted that the term “*currency*” is not defined in the ITO, and as such, the definition of this term should be derived from general Israeli commercial law. Applying the definition of “*foreign currency*” in the Bank of Israel Law, the Court ruled that Bitcoin does not maintain the physical, legal, or economic properties of currency required under such definition.

First, the Court rejected the argument that Bitcoin constitutes currency since it does not maintain the same physical and tangible properties as a “banknotes or coins.” The opinion states that while Bitcoin is not considered illegal means of payment, it does not maintain the required legal properties of *legal tenders* under the Bank of Israel law, and therefore cannot be regarded as currency.

Second, the court noted that Bitcoin lacks the economic features of currency since it does not enjoy the widespread public trust provided to traditional regulated currencies. As part of its analysis, the Court determined that the tax exemption for linkage differentials based income is intended to avoid taxing income that does not reflect an increase in purchasing power. In contrast, profits derived from Bitcoin constitute a significant increase in wealth and purchasing power.

Third, the Bitcoin's frequent use for illicit activity in the Darknet and gambling, coupled with its high volatility makes it difficult to perceive it as fulfilling the substantive function as *a medium of exchange that stores value*.

Finally, the Court ruled, in alignment with the Israeli Securities Authority position, that Bitcoin does not fall under the definition of security, as defined in the Israeli Securities Law as argued by the Appellant. The Court reasoned that, under the ITO, a security is an instrument that provides rights in, and is issued by, a corporation. The Court ruled that Bitcoin does not provide any such right in a corporation, and doubted whether a computer network could constitute a corporation for this purpose.

While the Court unequivocally rejected the Appellant's claims, it noted that future change in the economic or legal environment may lead to a reevaluation of Bitcoin's classification. Moreover, the Court noted that Bitcoin, which is regarded as “the first draft for future crypto-currencies,” may set the stage for other digital coins that may become actual currency.

In this precedential decision, the Court grappled with an issue of first impression regarding the appropriate tax treatment for cryptocurrency as a digital asset. We expect future case law to provide further guidance with respect to other tax aspects of Bitcoin and other cryptocurrencies, such as tax treatment of crypto-currencies' losses, treatment of cryptocurrencies which are linked to other digital assets, deductions and more.

For further information please contact:



Daniel Paserman
Adv. (CPA), TEP, Head of Tax
✉ paserman@gornitzky.com



Dr. Yehonatan Shiman
Associate
✉ yehonatans@gornitzky.com