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IRS Issues New Guidance on Cryptocurrency 'Staking'

SUMMARY

On July 31, 2023, the IRS issued Revenue Ruling 2023-14 (the "Ruling"), addressing the tax treatment of cryptocurrency received as rewards for validating blockchain transactions on a proof-of-stake consensus mechanism (such activity, "staking", and such rewards, "validation rewards"). The Ruling holds that the validation rewards are includible as gross income when the taxpayer can freely dispose of them without restrictions.

DISCUSSION[1]

Background

Cryptocurrencies are virtual currencies that are digitally recorded on a distributed ledger, usually a blockchain. To maintain legitimacy of the blockchain and its associated cryptocurrency, blockchain transactions must be verified by a consensus mechanism before the transaction is accepted and updated on the blockchain. Although many major cryptocurrencies still use "proof-of-work" consensus mechanisms, which require participants to "mine", or solve complex, energy-intensive, cryptographic puzzles to verify the transaction, a growing number of cryptocurrencies use "proof-of-stake" consensus mechanisms.

Under the proof-of-stake consensus mechanism, participants are allocated validation rights by depositing, or "staking," the native cryptocurrency within certain protocols in the blockchain network. Generally, staked cryptocurrencies (and sometimes the validation rewards earned) are locked up for a specific period of time and cannot be transferred, sold or be otherwise utilized by their owners during staking. Those that successfully validate the cryptocurrency transactions are rewarded with additional units of the native cryptocurrency, or "validation rewards"; whereas unsuccessful validations may be subject to a penalty, including the loss of the staked cryptocurrency, or "slashing."

Revenue Ruling 2023-14

The Ruling describes a cash-method taxpayer who owns units of cryptocurrency "M". The taxpayer participates in a proof-of-stake consensus mechanism for M and stakes a portion of their M units. Under the consensus mechanism, the taxpayer receives additional units of M as a validation reward, but may not sell, exchange or otherwise dispose the awarded units until a specified later date. The Ruling holds that the taxpayer must include the fair market value of the validation rewards received as gross income for the taxable year that includes the first date the taxpayer gains "dominion and control" over the additional units, which the Ruling equates with the date the taxpayer is allowed to dispose of such units.

In reaching its holding, the IRS relied on existing law stating that gross income includes all income from whatever sources, including compensation for services,[2] in "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[3] The Ruling treats valuation rewards "received" as an "accession to wealth" for the taxpayer, the "dominion and control" over which gives rise to such income. The IRS also held that the amount of gross income included is the fair market value at the date and time at which it is reduced to undisputed possession.[4] The IRS further noted that this treatment of validation rewards is consistent with its previous guidance, which concluded that the fair market value of the mining rewards under "proof-of-work" consensus mechanisms must be included in the taxpayer's gross income as of the date that the cryptocurrency was mined.[5]

Impacts

Prior to the Ruling, certain taxpayers and practitioners questioned whether validation rewards minted as part of a consensus mechanism were income upon receipt, or a self-created asset "like a baker who bakes a cake . . . or a writer who writes a book", which would not be taxable until a later taxable disposition of such assets.[6] The Ruling makes it clear that the IRS views that it is income when the taxpayer "receives" the validation reward and is allowed to dispose the interest, but does not identify where the "receipt" is actually coming from. Notably, in *Jarrett* v. *United States*, the taxpayer took the view that the validation rewards are self-created property.[7] The district court dismissed the case as moot as the IRS unilaterally issued a refund to the taxpayer. An appeal of the mootness determination is currently before the Sixth Circuit.[8]

The Ruling leaves open some questions regarding proof-of-stake consensus mechanisms. For example, the Ruling also does not discuss "gas" fees, or transaction fees that the cryptocurrency end users pay to the cryptocurrency network (and ultimately to the stakers) for the user's transaction to be recorded and validated, which is separate from the validation rewards earned through the consensus mechanism. The Ruling also describes slashing, but does not discuss the tax consequences if such slashing actually occurs.

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ENDNOTES

[1] References herein to a "Section" are to sections of the Internal Revenue Code and the Treasury regulations ("Treasury Regulations" or "Treas. Reg.") promulgated thereunder.

[2] The Ruling, however, specifically states that it does not address the application of Section 83 to the validation rewards, in which property received in connection with performance of services is included as income of the taxpayer "at the first time the rights of the person having beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier."

[3] *Commissioner* v. *Glenshaw Glass Co*., 348 U.S. 426 (1955); Section 61; Treasury Regulations Section 1.61-1(a).

[4] Section 61(a); *Koons* v. *United States*, 315 F.2d 542 (9th Cir. 1963); *Rooney* v. *Commissioner*, 88 T.C. 523, 526-527 (1987); Treasury Regulations Section 1.61-2(d)(1).

[5] IRS Notice 2014-21, Q&A 3 and 8.

[6] *Jarrett* v. *United States*, No. 3:21-cv-00419 (M.D. Tenn.), Compl. ¶ 7.

[7] *Jarrett* v. *United States*, No. 3:21-cv-00419 (M.D. Tenn.).

[8] Docket No. 22-06023 (6th Cir. Nov. 23, 2022).

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