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Crypto Case Failed To Clarify Taxation Of Staking Rewards

By **Mark Howe, Linda Swartz and William Walsh**
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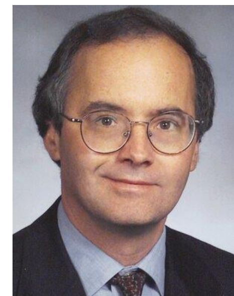
Mark Howe

Linda Swartz

William Walsh

Crypto industry groups had hoped to use the tax refund case of Jarrett v. U.S., in the U.S. District Court for the Middle District of Tennessee, as the vehicle to prove that rewards received by a crypto validator on proof-of-stake cryptocurrencies, called staking rewards, only trigger gain upon the ultimate disposition of the reward, rather than constituting taxable income upon receipt.[1]

However, the IRS apparently decided it was not ready to fight that battle and sought to moot the taxpayer's suit by actually refunding — without explanation — the amount the taxpayer claimed to have overpaid on the staking rewards.

The taxpayers, along with the cryptocurrency policy group Coin Center as amicus, asserted that the case should continue despite the refund, arguing the IRS should not be able to avoid pending litigation by tendering a preemptory settlement, and because the tax treatment of staking rewards was a recurring question for the Jarretts as well as a question of public importance warranting an exception to the case's mootness.

On Sept. 30, the court agreed with the IRS, ruling it no longer had subject matter jurisdiction and dismissing the case.[2]

Proof-of-Stake Validation and Staking Rewards

Cryptocurrencies are decentralized mediums of exchange that operate independent of national borders. However, to make these systems work, there still must be a trusted method of validating the decentralized digital transactions to prevent fraud and errors.

Historically, bitcoin and the other major cryptocurrencies performed this validation function through a proof-of-work model that demanded large amounts of computing power — and correspondingly huge energy consumption. As a result, many cryptocurrencies are utilizing a more ecologically friendly proof-of-stake model of validation.

While bitcoin is clinging to the proof-of-work model for now, another established cryptocurrency —

ethereum — migrated to the proof-of-stake model in mid-September, and the savings in computing, environmental and energy costs are likely to make the proof-of-stake model the predominate one in the future, despite its being arguably a bit less secure than the traditional proof-of-work approach.

The increasing adoption of proof-of-stake validation has also raised the importance of resolving the tax treatment of staking rewards received by validators in proof-of-stake systems.

While the IRS announced in Notice 2014-21 that rewards received for performing proof-of-work validations — or proof-of-work mining rewards — give rise to immediate taxable income based on the value of the reward when received, the IRS has yet to formally announce its view on the treatment of staking rewards.[3]

Most practitioners have assumed that, since the validation function remains the same under either proof-of-work or proof-of-stake methods, the IRS would treat staking rewards as immediately taxable in an amount equal to their current value similarly to proof-of-work mining rewards. However, taxpayers, and their supporters in the crypto industry, have argued that the proper tax analysis for staking rewards should result in taxation being delayed until the validator disposes of its staking reward.

In Jarrett, the IRS paid a refund to a proof-of-stake validator, rather than contest the issue in court. This action has focused attention on the question whether the IRS is having a change of heart regarding the treatment of validation rewards, is just holding out for more favorable litigating terrain, or hopes to bolster its position through future regulatory or legislative action. The answer remains to be seen.

Both proof-of-work and proof-of-stake systems perform the actual validation function required by any cryptocurrency in an equivalent manner, and both systems reward the validator by granting the validator newly minted cryptocurrency as a reward. In form, the difference between the systems is in how they select validators.

In proof-of-work systems a validator must devote time and computing power to solve a complex puzzle. In proof-of-stake systems validators are generally selected based on how much cryptocurrency they post as a stake. But, this really just obscures a more fundamental difference between the systems, which is how they dissuade validators from either intentionally or inadvertently acting in ways that undermine the integrity of the currency.

In proof-of-work systems the so-called stick that dissuades such detrimental behavior is the astronomical computing cost and effort that would be required to insert corrupt data into a blockchain that has been validated by so much prior proof-of-work. Essentially the cost of subverting the integrity of the results of the prior proof-of-work process is so costly that it outweighs any potential benefit, even if there was the computational ability to do it.

In contrast, a proof-of-stake system relies on two elements to dissuade bad validations: (1) the practical reality that a bad actor would need to control more than 50% of the currency to rig a fraudulent consensus validation; and (2) the fact that validators are required to post their own cryptocurrency holdings as a stake which can be reduced — and in extreme cases completely eliminated — as a penalty for engaging in prescribed detrimental behaviors.

The key question then is whether the distinctions in how validators are chosen — and so how the cryptocurrency is protected — warrant taxing the rewards associated with the two systems differently.

The Jarrett Case

In 2020, Joshua and Jessica Jarrett filed an amended 2019 tax return, and sought a refund for taxes paid on staking rewards earned on the proof-of-stake cryptocurrency Tezos that they previously included as income on their 2019 tax return. The IRS did not respond and approximately a year later, the Jarretts filed a lawsuit for the refund.

In their complaint, the Jarretts asserted that staking rewards should not be taxable upon receipt on two grounds. First, staking rewards are akin to self-created property, which does not give rise to income upon creation. Second, the receipt of staking rewards actually dilutes the economic value of the cryptocurrency, and therefore does not economically result in an overall increase in value that constitutes income.

In regard to the self-created property argument, the complaint analogized the act of staking to a baker that bakes a cake or an author that writes a book. The tax law is clear that neither the baker nor the author realize any taxable income on the property they created until they dispose of it.

Thus, the Jarretts argued, by using their existing cryptocurrency to create additional currency — the staking reward — they were just creating property, like the baker or the author, rather than being paid for performing the validation or solving a proof-of-work puzzle.

In this vein, the structure of the proof-of-stake system that requires staking existing currency as the essential element of obtaining the validation right — like using your mixer to make the cake — could be a distinguishing factor from validator's activity in a proof-of-work system. The Jarretts emphasized that the staking rewards were newly created property that arose from their staking activity and not from existing property transferred to them by a third party.

The self-created property argument does not address the fact that the underlying validation performed by the validator could itself be viewed as a service rendered to all holders of the cryptocurrency. That is, the IRS might still argue that a staking reward, even though newly minted, is more like a payment in-kind to a chef hired to bake cakes for a party, than it is to a baker creating property for himself that he can then choose to consume or sell. The Jarretts' complaint did not address this argument.

With respect to the Jarretts' argument that staking rewards should not be taxable upon receipt since the rewards actually result in a dilution of the underlying cryptocurrency's value, the argument presupposes that staking rewards are distributed on a pro rata basis to all holders. This depends on the structure of the particular proof-of-stake system and so may not always be the case.

Sadly, neither of these intriguing arguments were ever analyzed on their merits in the Jarrett case since, as discussed above, the case was dismissed as moot following the payment by the IRS of the claimed refund amount. Essentially, the court relied on the nature of a claim for refund as being limited to the specific tax year at issue.

Since the IRS had refunded the full amount the Jarretts claimed they overpaid for 2019, there was no longer any controversy for the court to resolve regarding the taxpayer's liability for 2019, and a refund claim cannot be used to litigate prospective issues applicable to other years.

The court also rejected the taxpayer's characterization of the refund as merely an offer in settlement and was unpersuaded that the public importance of the issue warranted continuing a mooted case.

After the dismissal in Jarrett, the appropriate characterization of staking rewards for purposes of taxation remains uncertain. Perhaps the IRS is reconsidering its position that staking rewards are income upon receipt. But the failure of the IRS to explain its rationale for issuing the refund to the Jarretts may indicate that the refund merely reflects a strategic decision to fight the battle over the tax treatment of staking rewards on more favorable terrain at a future date.

Either way, the decision has bought the IRS more time to hone its thinking on staking rewards, but left the crypto industry frustrated and disappointed at the lack of a clear resolution on the staking issue.

In the aftermath of this dismissal, taxpayers are still without clarity on the tax treatment of staking rewards, and are left trying to interpret whether the refund payment signals that the IRS accepts the Jarrett's position on the taxation of staking rewards, is holding out for more favorable litigating terrain, or wishes to bolster its position through future regulatory or legislative action instead.

The Post-Jarrett Landscape

In any event, it is possible that other taxpayers engaged in staking will file similar refund claims, which, if denied, could give rise to future clarifying litigation. Whether the IRS will continue to accede to paying such refunds rather than litigating is unclear.

One possibility that may have influenced the government's decision to pay the refund rather than pursue the case is potential legislation, which, if enacted, would side with the Jarretts that income on staking rewards should be deferred until disposition.

Bipartisan legislation introduced in the U.S. Senate last summer, the Lummis-Gillibrand Responsible Financial Innovation Act, would provide that both proof-of-work mining rewards and staking rewards, generated from mining and staking activities respectively, are not taxable until subsequent disposition of those tokens.[4]

The act would therefore go further than Jarrett in legislatively repealing the immediate taxation of proof-of-work mining rewards received in mining activities as provided in Notice 2014-21. Perhaps the potential legislation is a factor in the IRS's decision to abstain from this fight.

At the other extreme, the IRS may be planning to release additional guidance in this area soon, which could potentially be used to bootstrap an IRS argument for taxing staking rewards in the same manner as proof-of-work mining rewards.

At this point, the IRS' motives are opaque, and taxpayers, advisers, and the crypto industry are left frustrated and disappointed at the lack of a clear resolution on the taxation of staking rewards.

Mark Howe is a partner at Cadwalader Wickersham & Taft LLP.

Linda Swartz is a partner and chair of the tax group at the firm.

William Walsh is an associate at the firm.

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[1] Jarrett v. United States, No. 3:21-cv-00419 (M.D. Tenn. 2022).

[2] Jarrett v. United States, No. 3:21-cv-00419, 2022 WL 4793235 (Sept. 30, 2022).

[3] Notice 2014-21, 2014-16 I.R.B. 938 (2014).

[4] Lummis-Gillibrand Responsible Financial Innovation Act, S. 4356, 117th Cong. § 208 (2022).