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IRS Releases Guidance on Cryptocurrency 'Staking' Rewards

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On July 31, 2023, the Internal Revenue Service (IRS) released **Revenue Ruling 2023-14**, which addresses the US federal income tax treatment of cryptocurrency units (commonly referred to as coins or tokens) that are received by a taxpayer as a reward for validating transactions that occur on a blockchain network utilizing a proof-of-stake consensus mechanism ("staking" rewards). The long-anticipated ruling definitively sets forth the IRS' position that staking rewards are income for US federal income tax purposes.

Background

Cryptocurrency is a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger. Many cryptocurrencies utilize blockchain technology, a specific type of distributed ledger technology. The integrity of the blockchain must be maintained in order to preserve the cryptocurrency's function and utility. That blockchain integrity is maintained by nodes – or individual computers that hold copies of the distributed ledger, run the related software and validate transactions that occur on the blockchain. Validation occurs when blockchain transactions are determined to be legitimate and are recorded as new blocks on the blockchain. The process of validating a transaction usually involves the participation of multiple validators who are selected to participate in the validation process by the blockchain protocol. Validators typically are rewarded with tokens that are native to the blockchain network when the protocol determines that the validation process occurred properly, and they can be penalized through "slashing," or forfeiture, of tokens if validation is conducted in a manner that is detrimental to the blockchain.

The protocols that make up the validation process are referred to as consensus mechanisms. Two common categories of consensus mechanisms are "proof of work" and "proof of stake." The proof-of-work consensus mechanism involves using highly specialized and energy-intensive computers to solve and publicly share the solution to a cryptographic puzzle. Bitcoin is an example of a cryptocurrency that uses the proof-of-work consensus mechanism. Persons who successfully validate bitcoin transactions receive bitcoins as a reward through a process known as "mining." As discussed in **this October 2019 Cooley alert** on IRS guidance for cryptocurrency, under FAQ #8 of **IRS Notice 2014-21**, a taxpayer who "mines" bitcoin or other virtual currency on a proof-of-work consensus mechanism generally must include in gross income the fair market value of the virtual currency received in connection with the mining activity. Notice 2014-21 and subsequent IRS guidance do not specifically address staking rewards received under a proof-of-stake consensus mechanism.

The proof-of-stake consensus mechanism differs from proof of work in that validators are selected to participate in the validation process based on a variety of factors – one of which includes the quantum of the validator's "staked" coins or tokens, meaning those that the validator locks up for a certain period of time for use in the validation process. The staked tokens are collateral to ensure that the validators conduct the validation process in the manner required by the protocol. Coins or tokens that a validator stakes cannot be traded during that period and are subject to slashing. Proof-of-stake consensus mechanisms generally are viewed as more environmentally friendly than proof-of-work consensus mechanisms because the staking process is not as energy intensive. Holders of cryptocurrency on proof-of-stake blockchains that do not participate in the validation process do not earn rewards.

Revenue Ruling 2023-14

Revenue Ruling 2023-14 describes a situation in which a taxpayer on the cash method of accounting owned 300 units of an unspecified cryptocurrency, staked 200 of such units, validated a new block of transactions on the blockchain associated with such cryptocurrency, and received two units as a staking reward (reward units), which were nontransferable for a short period of time (lock-up period). On the day following the lock-up period, the taxpayer had the ability to sell, exchange or otherwise dispose of the reward units. The IRS ruled that the taxpayer was required to include the fair market value of the reward units in gross income after the lock-up period because the taxpayer had an accession to wealth when the taxpayer gained "dominion and control" over the reward units. The taxpayer was held to have gained "dominion and control" over the reward units on the day following the lock-up period, when the reward units became freely transferable.

Analysis

The IRS view set forth in Revenue Ruling 2023-14 that the receipt of staking rewards is taxable is directionally consistent with prior guidance in Notice 2014-21, which indicates that cryptocurrency rewards received as a result of mining on a proof-of-work blockchain network are taxable upon receipt.

Revenue Ruling 2023-14 implicitly rejects an alternative position advanced by certain taxpayers and practitioners that would treat staking rewards comprised of newly minted tokens as self-created property that should not be taxable until the taxpayer disposes of them in a taxable transaction.

For example, in ***Jarrett v. United States***, the taxpayer filed a claim for a refund relating to a staking reward previously included in gross income in the year of receipt. Before the case was considered by the court, the IRS granted the taxpayer's request for a refund. The taxpayer attempted to reject the refund granted by the IRS in an effort to preserve his claim at the district court. However, the district court dismissed the taxpayer's case as moot because the refund had been granted and therefore did not consider the merits of the taxpayer's argument. The case is **currently on appeal**. It is not entirely clear why the IRS granted the taxpayer's refund request in Jarrett, but it apparently preferred to establish principles through subregulatory guidance rather than through the courts.

The ruling states that it "does not address issues that may arise under rules not specifically cited, such as section 83." Under Internal Revenue Code section 83(a), if a taxpayer receives property "in connection with the performance of services," that property is generally valued and included in income by the service provider "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." If section 83 applied to the reward units in Revenue Ruling 2023-14, it would appear the taxpayer should have been subject to tax upon receipt, not upon expiration of the lock-up period, because the ruling does not indicate that the reward units were subject to any substantial risk of forfeiture. The ruling, however, gives no explanation as to why the "dominion and control" test, rather than section 83, applies to the reward units.

Although Revenue Ruling 2023-14 and prior IRS guidance clarify certain aspects of cryptocurrency transactions, a number of US federal income tax questions regarding cryptocurrency remain unresolved. Revenue Ruling 2023-14 is limited to the staking rewards received by a validator and does not address the taxation of other types of transaction fees, such as "gas" fees paid to the validator for the cost of the computing power used in the validation process. It also does not provide guidance on how units received as staking rewards should be valued for purposes of calculating the validator's taxable income. Cryptocurrency holders and exchanges should continue to consult with tax advisers to ensure compliance with applicable tax laws.

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