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Tax

August 7, 2023

IRS Rules That Cryptocurrency Staking Rewards are Taxable

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The Internal Revenue Service (IRS) has ruled that a cash-method taxpayer that stakes cryptocurrency native to a proof-of-stake blockchain is subject to tax on additional cryptocurrency it receives as rewards when validation occurs. The ruling, Revenue Ruling 2023-14, defines cryptocurrencies as "convertible virtual currencies" and describes the blockchain technology utilized by cryptocurrencies as well as the process by which the integrity of a blockchain is maintained via the validation of transactions. It goes on to state that "[i]n a proof-of-stake consensus mechanism, persons who hold cryptocurrency may participate in the validation process by staking their holdings, if they hold the requisite number of units of a particular cryptocurrency, . . . [and that] . . . validators may be selected by the protocol for the blockchain associated with the specific cryptocurrency based on a variety of factors. . . . These validators confirm transactions and add blocks to the blockchain in accordance to the protocol. If the validator is chosen by the protocol and validation is successful, the validator will receive a reward."

The ruling provides the example of a cash-method taxpayer that owns 300 units of M, a cryptocurrency, for which transactions are validated by a proof-of-stake consensus mechanism. The taxpayer stakes 200 units of M and validates a new block of transactions on the M blockchain, receiving two units of M as validation rewards. During a brief period, the taxpayer lacks the ability to dispose of the two units. The IRS holds in the ruling that the value of the two units of M that the taxpayer received for staking units and validating transactions on the M blockchain is includible in the gross income of the taxpayer as of the date that the taxpayer has the ability to sell or otherwise dispose of those units.

This IRS conclusion that a taxpayer is taxable with respect to its receipt of staking rewards comes while there is pending litigation over whether staking rewards should be taxable as of the date that the receiving taxpayer has the ability to sell or otherwise dispose of such rewards or whether they should instead be taxable only when later sold, under a theory that the rewards should be treated as self-created property (being analogized to a newly baked loaf of bread, which is not taxable to the baker until it is sold). Therefore, there may be another decision on this issue, this time from the Sixth Circuit, in the near future. The IRS ruling is a reflection of the IRS' view of the law, and courts do not have to agree. We will be watching for further developments and guidance from the IRS and the courts on this and other related issues.

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