Taxation of Virtual Currency Staking Activities

Article By:

Tax Practice Group McDermott Will Emery

Stakers—taxpayers involved in proof of stake (PoS) validation of blockchain transactions—are operating in uncharted tax waters. Treasury and the IRS have provided no guidance regarding when or whether staking rewards are included in taxable income. This article reviews various considerations that may help stakers document activities, rewards and expenses that support their federal and state tax positions.

Taxpayers involved in proof of stake (PoS) validation (stakers) have no direct tax guidance as to the tax treatment of their staking rewards, which makes it difficult for them to evaluate possible tax positions as they prepare their federal and state tax returns. This means that taxpayers must adopt a tax methodology that they believe is supportable on audit, subject of course to judicial review. This article discusses federal tax issues—as of the date of publication—of income and expenses associated with virtual currency PoS staking activities.

Virtual currencies are based on blockchains (digital ledgers) that, given the absence of a trusted third party, require some type of consensus algorithm to achieve consensus among participants (distributed consensus) as to the validity of groups of transactions (blocks). This validation process is designed to assure that the next block of transactions added to the blockchain represents the most current transaction, eliminating the possibility of double-spending coins, tokens or units. The two principal mechanisms for achieving distributed consensus are PoS and proof of work (PoW). Virtual currencies such as Tezos rely on PoS mechanisms. Virtual currencies such as Bitcoin rely on PoW. Both PoS and PoW are subject to the terms of the respective protocol in place for the particular transactions being verified or confirmed. (There are wide variations between and hybrids of PoW and PoS blockchains.) For a discussion of PoW mining activities, see McDermott's article, "Taxation of Virtual Currency Mining Activities."

Virtual Currency Staking

In PoS systems, stakers are chosen by combinations of random selection plus the amount of units making up their stake and/or the amount of time they have agreed to lock up the stakes in a specific digital wallet. Staked units support the blockchain operations. Unlike the mining activities of PoW blockchains miners, stakers validate new blocks by forging on the next block without mathematical computations. PoS protocols require stakers to hold and stake a minimum number of units to participate in the validation process. As staking rewards, stakers receive a specified number of units generally taken from other participants as transaction fees. These reward units redistribute the ownership stakes away *from* computers (nodes) that do not put up a stake to those nodes that put up stakes.

When Are Staking Rewards Includable in Taxable Income?

Before turning to the issues of when staking rewards are included in taxable income, it is useful to consider what the IRS has said about mining fees in PoW blockchains. IRS Notice 2014-21 (2014-16 I.R.B. 938, Q&A 8) sets out the IRS's position that miners receive taxable income when they receive mining fees. Notice 2014-21 is silent, however, about the taxation of staking activities. The Notice says that miner's fees are taxable at their fair market value as ordinary income *as of the date* they receive the units. The IRS also asserts that miners cannot wait to include the value of these units in income until they subsequently purchase goods or services or otherwise convert these units into US dollars or another currency. According to the Notice, all Bitcoin miners—even small-scale miners that receive minimal fee income—must report their mining fees as ordinary income when they receive them.

Because the Notice does not address staking and there is no other governmental guidance, stakers take a wide range of tax positions with respect to the taxation of staking rewards. Some taxpayers take the position that staking rewards are sufficiently similar to payments received by successful virtual currency miners, and that staking rewards should be taxed under the Notice upon receipt (see McDermott's article, "Taxation of Virtual Currency Mining Activities"). This tax position would need to take into account inflation payments that are made to all stakers.

Other taxpayers assert that their staking rewards are not taxable until they sell, exchange or otherwise dispose of the rewards. Some of these taxpayers argue that staking rewards are more like the extraction of actual minerals where some taxpayers do not pay tax until they subsequently dispose of the extracted minerals. (Taxpayers should consider Rev. Rul. 77-176 and the oil and gas and mining industry responses with structuring tax partnerships to minimize the current taxability of certain extraction operations; *see* Bitkker and Lokken, *Federal Taxation of Income, Estates & Gift*s.) Taxpayers seeking to rely on the tax treatment of oil and gas transactions, however, need to be aware that oil and gas transactions are quite specialized, "primarily because many of the basic concepts were the result of liberal administrative interpretations of various sections of the Internal Revenue Code by the Treasury Department during a period when the Congressional policy was to encourage the development and production of oil and gas properties" (*BNA Tax Portfolio, Oil and Gas Transactions*, No. 605, 2017, A-1). Obviously, there is no assurance that similarly favorable policies and interpretations will ultimately be applied to virtual currency.

Other taxpayers take the position that their staking rewards are not taxable at receipt because their staking activities are similar to harvesting of agricultural products or the offspring of livestock. They argue that staking rewards should not be taxable until disposed of.

And yet other taxpayers assert that staking rewards are not taxable under I.R.C. § 61 because their rewards (or at least some portion of the rewards) do not meet the definition of income, while others assert that staking rewards do not represent an "undeniable accession to wealth" that is "clearly realized" and to which the taxpayer "has complete dominion" (*Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955)).

There is no direct authority with respect to any of these tax positions, so taxpayers must proceed with caution.

Are Stakers in a Trade or Business?

To deduct business expenses related to staking operations, stakers need to be "traders" (who seek profits based on market fluctuations, not from passively overseeing their virtual currency investments) or "dealers" (who enter into virtual currency transactions with their customers in the ordinary course of their business). Whether a staker's activities rise to the level of a trade or business boils down to two things: the volume of their transactions and their ability to establish that these activities constitute an active trade or business (*Paoli v. Commissioner*, 54 T.C.M. (CCH) 1574, 1578 (1988); *Chen v. Commissoner*, 87 T.C.M. (CCH) 1388 (2004)). The phrase "trade or business" is not defined in the Internal Revenue Code or Treasury regulations. Whether mining activities qualify as a trade or business is a question of fact. Various factors are considered, with no one factor dispositive. Elements of a trade or business include (1) activities that occupy "the time, attention and labor" of the taxpayer for the purpose of "a livelihood or profit"; (2) the continuity and regularity of the taxpayer's activities; and (3) a profit motive.

In *Commissioner v. Groetzinger*, for example the Supreme Court held that a professional gambler could be in a "trade or business" if the gambler devotes his full-time activity to gambling and it was his intended livelihood source. In this situation, his activity should be regarded as a trade or business "just as any other readily accepted activity" (480 U.S. 23 (1987)).

Stakers who delegate their tokens to others to stake are not likely to have activities that would rise to the level of a trade or business without more activities.

If staking activities rise to the level of a trade or business, stakers can deduct appropriate trade or business expenses (I.R.C. § 162). Deductible staking expenses include, for example, office rental and other office expenses, salaries, computer equipment, software programs, Internet access fees and electricity. Deductible business expenses and depreciation reduce their taxable income.

Those stakers who engage in staking activities for investment or as a hobby are not in a trade or business. As a result, they do not have deductible business expenses (see McDermott's article, "Virtual Currency Losses Disallowed on Infrequent Activities"). Limited itemized deductions might be available for some investment expenses, but such stakers do not have business expenses deductible against income. (*See* Chapter 10 of Publication 334, *Tax Guide for Small Business*, for more information on self-employment tax and Publication 535, *Business Expenses*, for more information on determining whether expenses are from a business activity carried to make a profit.)

Selling, Exchanging, or Disposing of Staking Rewards

Without regard to whether stakers treat their rewards as taxable upon receipt or only at the time when they sell their rewards, all stakers have a taxable event when they dispose of the units they receive from successful staking operations.

Staking Pools and Entity Considerations

Stakers often join together with others to pool their units to increase their stake and to, thereby, increase the likelihood that they will successfully validate blocks and receive staking rewards. These business relationships are subject to a wide range of financial relationships. Stakers who join with others, therefore, need to consider whether they will be treated as being in a partnership or taxable association, and they need to consider the federal and state tax implications of their entity selection. Stakers deemed to be in an entity are subject to the federal and state tax rules and tax reporting requirements that apply to such an arrangement.

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