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# 'Staking' Row Puts IRS On Hot Seat For Lack Of Guidance

By **Joshua Rosenberg**

Law360 (February 16, 2022, 6:51 PM EST) -- The Internal Revenue Service hasn't offered specific guidance regarding whether cryptocurrency staking constitutes taxable income upon receipt, leaving those engaged in the activity, which implicates substantial sums of potential government revenue, unsure about their tax obligations.


With one of the largest cryptocurrencies, Ethereum, having announced it's migrating to a proof-of-stake validating mechanism, considerably more investors likely will embrace staking. (AP Photo/Kin Cheung)

The lack of guidance on staking has come to a head in the case of Joshua Jarrett, a cryptocurrency investor from Tennessee who acquired digital tokens through staking. Staking is one of the consensus mechanisms that blockchains can employ to verify transactions. Jarrett **has argued in federal court** that the IRS doesn't have the right to tax the tokens he's staked until he's disposed of them.

Put another way, his position is that the act of staking, by itself, is not a taxable event.

That case could have been resolved by now if Jarrett, who has enjoyed the financial support of a crypto advocacy alliance and other anonymous backers, had accepted a refund offer from the IRS for the tokens he staked on the Tezos blockchain. But instead, he's decided to press forward in court in the hopes of securing a binding ruling on the matter.

With one of the largest cryptocurrencies, Ethereum, having announced it's migrating to a proof-of-stake validating mechanism — which is widely seen as a viable, more environmentally friendly alternative to the mining, or proof-of-work model — considerably more investors likely will embrace staking.

Therefore, the ultimate resolution — either through adjudication or IRS guidance — of whether staking, in and of itself, constitutes taxable income is bound to implicate vast sums of potential tax revenue. And since an outside organization is dedicated to help fund Jarrett's case and potentially others, the IRS may want to find a way to get ahead of the curve.

"There are a lot of people that use Tezos," Evan Davis of Hochman Salkin Toscher Perez PC told Law360. The IRS is "buying a big problem if they think that they can just sweep it under the rug — people who own Tezos are no doubt exchanging information about this case."

At the heart of this case is the question of whether cryptocurrency staking constitutes taxable income upon receipt or whether the crypto tokens one has acquired through staking aren't considered taxable until a disposition event. The Proof of Stake Alliance, a cryptocurrency advocacy organization helping to fund Jarrett's legal challenge, has been engaged with lawmakers and regulators for years to address that concern, Alison Mangiero, board member and acting executive director at the alliance, told Law360.

"Our role in the beginning was identifying this issue, bringing it to the forefront, and now we're happy to be supporting [Jarrett] and see where this thing goes in the coming months," Mangiero said.

Mangiero wouldn't say whether the alliance recruited Jarrett to file his lawsuit and also wouldn't comment on the number of anonymous backers helping to finance the case. Abe Sutherland, who is helping to represent Jarrett in court, is a legal adviser to POSA, Mangiero said. The alliance is waiting to see how Jarrett's case unfolds, but has not ruled out helping other taxpayers in the future who are similarly situated, Mangiero said.

In Notice 2014-21, the IRS said cryptocurrency mining constitutes gross income upon receipt. The agency, however, has never issued specific guidance related to staking rewards, which represents the open question at the heart of Jarrett's case. Blockchains can employ a variety of consensus mechanisms, including both mining and staking, to verify transactions and create new tokens.

Because the agency "never specifically addressed crypto staking prior to these recent events, people looked at that guidance and said one likely interpretation is that the IRS will also view staking rewards as income upon receipt," Naya Pearlman, partner in Berdon LLP's tax department, told Law360.

Alternatively, the IRS may choose to view mining as more labor-intensive than staking and apply different tax treatments as a result, she said.

Even against the backdrop of regulatory uncertainty from the IRS, the staking market continues to grow. By the third quarter of 2021, crypto assets using proof-of-stake mechanisms constituted $597 billion in market capitalization. And with Ethereum, the second largest cryptocurrency, committed to transitioning to the proof-of-stake model, those numbers are likely to grow even higher.

For his part, Jarrett pursued his case in federal court in 2021, **arguing that the government** didn't have the right to tax the tokens he staked before he had sold or exchanged them. Jarrett paid income taxes on some 8,800 tokens he acquired in 2019 on the Tezos blockchain by engaging in staking.

Crucially, Jarrett didn't sell or exchange the tokens in 2019, he has said in court documents. After paying income taxes for the tokens he staked, amounting to approximately $3,800, he sought a refund from the IRS in 2020, which the agency ignored, according to Jarrett.

In making his case, Jarrett likened his position to that of a baker who makes a cake or an author who writes a novel, claiming that he will realize income on the property he created if and when he sells or exchanges it. The IRS offered to furnish Jarrett with a tax refund for the amount he requested, which Jarrett rebuffed.

The IRS' capitulation represented a curious turn of events, Davis said.

"I can't recall in the 20 or so years that I practiced tax litigation, where in what is clearly a test case, the government tries to give up and walk away from it," Davis said. "It's very unusual, if not unprecedented."

Normally the IRS would be interested in litigating a test case like this one until it's resolved, Davis said, adding that the agency's decision to yield would make sense only if the agency were in the process of developing guidance that it could cite in future litigation.

Still, the matter has not been adjudicated fully and there are myriad reasons why the IRS took the position of offering a refund, Allison E. Raley, member of Mitchell Williams, told Law360. A trial in the case is scheduled for March 2023.

Meanwhile, the IRS' having backed down so far might invite other similar challenges, Davis said.

"As long as you have a well-resourced group behind it, if it were me, I would be throwing cases all throughout the United States," he said. "They've already got a cookie cutter complaint that the government simply pulled up its tent and walked away from, so why not do that dozens or hundreds of times? What's there to lose?"

It does seem that Jarrett has pinned the IRS in a corner, insofar as if the agency continues in the litigation, it risks being on the receiving end of an adverse opinion that would supersede whatever guidance it would have issued otherwise, Dale Werts, partner at Lathrop GPM LLP, told Law360. Likewise, the risk for Jarrett and his backers is that the court may rule on the issue in a way that would undermine their position, he said.

"The off-ramp for both parties is an IRS notice that either amends the 2014 one or a new notice which addresses staking," Werts said. "The IRS could do themselves a favor and the whole world a favor by giving us some guidance."

The IRS could not be reached for comment.

--Editing by Tim Ruel and Roy LeBlanc.