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Confusion On Crypto 'Staking' May Lead To Reporting Woes

By **Amy Lee Rosen**

Law360 (June 26, 2020, 1:43 PM EDT) -- A lack of IRS guidance on cryptocurrency "staking," in which a user receives virtual currency in exchange for holding tokens for a period of time, could sow confusion over when to report the currency as being obtained for tax purposes.

Staking is a less well-known method of obtaining virtual currency than mining, in which computers use vast amounts of processing power to crunch algorithms to validate transactions and create new blocks of cryptocurrency. In staking, which uses less computing power, a user locks up a portion of tokens or coins as stakes in exchange for the potential to receive new cryptocurrency.

Internal Revenue Service guidance on mining has been available since the agency issued Notice 2014-21 six years ago, treating cryptocurrency as property and clarifying that mined tokens are taxed as ordinary income when they are received. That approach was reinforced by a revenue ruling the agency released last October that addressed the tax treatment of cryptocurrency hard forks and airdrops.

The government has been silent, however, on the treatment of staked cryptocurrency, according to Wendy Walker, a solutions principal at software company Sovos Compliance LLC. There may be a tax reporting obligation for staking upon receipt of new cryptocurrency or when the new coin is sold or exchanged — or both — but users are not clear on the specifics, Walker said.

"If I hold my assets with you in your exchange and you give me additional property in exchange for that, when is that taxable?" Walker said. "This is an example of a reporting issue where a taxpayer has to make a decision about how to treat the transaction and [must] report it for tax purposes without having any guidance."

One possible approach would be to report cryptocurrency received from staking as ordinary income based on the value of the coin at the time of receipt, Walker said. Then, when the user sells the asset, capital gains or losses would be reported based on the value of the original basis at the time of receipt, she said.

Alternatively, a user could treat the sale or exchange of the currency received via staking as the taxable event, rather than the receipt of the tokens, meaning the user would report capital gains with a basis of zero, Walker said. That would allow the cryptocurrency user to pay taxes only at capital gains rates, which are more favorable than ordinary income tax rates, she said.

"Since staking is not discussed in the Notice 2014-21 nor in the updated [October] guidance from the

IRS, some taxpayers take a more aggressive approach and report staking rewards only when the asset is disposed of — so they only report capital gains," Walker said.

In 2018, the American Institute of Certified Public Accountants asked the IRS **to** clarify that cryptocurrency received from staking should be treated as ordinary income, the same way coins from mining are treated.

Proof of stake and mining's proof of work are the principal algorithms used to secure virtual currency networks. Because other versions also exist, any act of participating to secure currency in exchange for expecting a cryptocurrency award should be treated as ordinary income, the AICPA said in a letter to the IRS. The group suggested the agency take an approach in which the ordinary income recognized on staking would become the basis in the asset, and the holding period would start on the date that staking rewards are received. Any expenses related to staking should be allowed to be deducted as ordinary expenses, the letter said.

James N. Mastracchio, a tax partner at Eversheds Sutherland LLP, told Law360 that based on his understanding of the FAQs the IRS has issued on cryptocurrency, as soon as a cryptocurrency user has custody and control over a new coin that hasn't been exchanged or sold, ordinary income is recognized.

In the October revenue ruling, the IRS said cryptocurrency from airdrops — which occur when small amounts of cryptocurrency tokens are distributed, usually for free and for promotional purposes — should be treated as received if the holder can exercise dominion and control over the currency. So, a taxpayer who can transfer, sell, exchange or otherwise dispose of cryptocurrency received from an airdrop has received it as taxable income in the year of receipt, the guidance said.

It would make sense to apply the airdrop analysis to staked coins, because with staking there's an award of a coin and a holder has something new, Mastracchio said. If so, then once a holder has custody and control of a new coin from staking, then according to the IRS that person has new wealth that should be treated as ordinary gross income, he said.

Then, when the holder sells, exchanges or disposes of the new coin received from staking, the ordinary income originally declared is the basis in the coin, which is subtracted from the price at disposition to determine taxable profit or loss, Mastracchio said.

However, even under such an approach it is unclear whether the new coin has value, he said, because the introduction of new cryptocurrency may dilute the overall value of each coin, which makes it harder to calculate the fair market value of the newly received staked coin.

If cryptocurrency received from staking is treated as ordinary income, holders still don't know whether to report the cryptocurrency as rental income or other income on Form 1099-MISC, Walker told Law360. While both categories are treated as ordinary income, deductions and exceptions for rental income are not the same as those for "other income," she said.

Mining was originally designed to be accessible to anyone with standard computer equipment, but it now requires significant hardware resources and high amounts of energy, according to a letter sent to the IRS in January from the New York State Bar Association Tax Section. As a result, the letter said, staking became a popular alternative way to obtain cryptocurrency because of its reduced costs and energy consumption.

Staking can occur in two ways, the group said. In one method, an investor holds a private key outside a cryptocurrency exchange and the staking is performed through a wallet, a user interface. The other method is more direct but also requires greater technical expertise, the letter said.

Receiving staking coin from simply holding cryptocurrency in a wallet may further complicate tax reporting because the coin may be more like dividend interest than miscellaneous income, according to Rebecca Midori Ulich-Balinskas, of counsel at Morrison & Foerster LLP.

If a holder is passively involved and just keeps cryptocurrency in a wallet, the staked cryptocurrency may be perceived the same way as money held in a bank in exchange for a bonus, which would look more like a dividend, she said.

However, if a holder is more actively involved in the creation of the coin, by using computing power to sustain a blockchain ledger, that may look more like mining and be perceived as ordinary income, Balinskas said.

Even though the more passive dividend income would still be taxed at the ordinary rate, holders are uncertain about how cryptocurrency received from staking should be reported and which tax forms are appropriate for different types of staked coin, Balinskas said.

"This is why IRS guidance would be really helpful," she said.

--Editing by Robert Rudinger and Neil Cohen.