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Crypto Tax Guidance Confusion Heralds Court Battles to Come (1)

By Caleb Harshberger

- IRS staking guidance likely to spur court battles
- Regulations from IRS, Treasury expected months ago

IRS actions on crypto staking and absent promised regulations from Treasury are expected to spark new legal fights over arguments about proper categorization of crypto rewards.

The IRS last month said in guidance that cryptocurrency tokens created through staking must be reported as income as they are valued when they arrive in the staker's possession and then as capital gains after they are sold—similar to its longtime guidance on crypto mining.

"Everyone kind of expected what the IRS was going to say," said Miles Fuller, head of government solutions at TaxBit and a former senior counsel at the IRS Office of Chief Counsel. "I think what's next is we'll find another lawsuit is very quickly in the future."

Stakers say the guidance could come with a host of reporting challenges and fails to take into account the rapidly changing ecosystem of crypto staking and the technology behind it.

Many saw the move as contradicting the agency's previous decision in a crypto tax case to send a roughly $4,000 refund to Joshua and Jessica Jarrett, who had argued the IRS should categorize the rewards as self-sourced property—like paintings, grown crops, or mined minerals—rather than income.

The Jarretts subsequently argued they can decline the refund in the hopes of seeing the case through the courts and argue that the IRS guidance should be reversed. A federal appeals court ruled Friday that the lawsuit became moot after the IRS issued the refund.

Many tax professionals weren't surprised by the IRS's actions, or the guidance.

"We thought, 'Of course they'll concede it. It's a $4,000 issue. Why wouldn't they concede it?'" said Lisa Zarlenga, Steptoe & Johnson LLP partner. "In the crypto world, they said, 'Oh my gosh, they conceded it, we win, they agree with us.' And they still are pressing on."

The confusion—and lingering questions unaddressed in the guidance—could open the door to stakers willing to bet the agency will fold again if challenged in court, Fuller said. Many expect to see the courts called in to answer the question of whether the staking rewards are income upon receipt.

"The IRS didn't help themselves by conceding the lawsuit, especially when it was going to produce guidance saying, 'Yes, it was," Fuller said. "I believe the question will get decided by a judge unless some piece of legislation gets passed that says, 'Hey, this is the answer.'"

Self-Sourced Property?

Until then, critics say the guidance doesn't address the arguments they've made about crypto staking gains as self-sourced property rather than income: If staking rewards are income, who is the employer? And is the filing of 1099s required?

Jason Schwartz, a partner at Fried, Frank, Harris, Shriver & Jacobson LLP, argues in this case that there is no payer, only a decentralized network, and that tax law regularly requires there to be a payer or some sort of employer to tax income.

"Tax law virtually always requires the existence of a payer, such as an employer or other counterparty, for taxable income to accrue to someone," Schwartz said. "Even treasure trove discoveries are deferred payments."

The guidance also doesn't address the new and changing ways investors are staking cryptocurrencies, such as pools or delegated staking where investors pool tokens together and share the rewards.

"In many ways I think the revenue ruling is very clear: Newly created tokens are income," said, Garrett Brodeur, an associate at Kostelanetz LLP. "But not all staking rewards are newly created, so how are those to be treated?"

The guidance also poses serious reporting challenges to stakers, particularly those who don't want to go through centralized exchanges.

Stakers often receive many rewards over the course of a day, sometimes minutes apart, and all at different market values. Those not staking through a centralized exchange often lack the infrastructure to keep track of the rewards and their values throughout the day.

"You probably have a lot of people out there that aren't reporting," said Tom Shea, EY Americas Financial Services crypto tax leader. "I'll say, just attending conferences, there are people who want to report but they don't have the infrastructure built to do it, and they're not sure how to do it, or they have a tax adviser who doesn't know how to do it."

All this likely adds up to future court battles.

“If I was going to advise clients in staking transactions, I would say, ‘Follow the guidance, follow the revenue ruling,’ but with that said, certainly the time is ripe for someone to bring another suit challenging the IRS position on staking,” said Caitlin Tharp, an associate at Steptoe & Johnson LLP.

Missing Regs

Many questions are expected to be addressed by regulations long promised by the Treasury Department and IRS following the passage of the Inflation Reduction Act.

Those rules hit OIRA early this year, went back to Treasury, and haven’t been seen since. Senators Elizabeth Warren (D-MA), Bob Casey (D-PA), Richard Blumenthal (D-CT), and Bernie Sanders (I-VT) sent a letter this month asking the agencies to release the rules.

Senators Kirsten Gillibrand (D-N.Y.) and Cynthia Lummis (R-Wyo.) proposed a bill that, among other things, would reverse the IRS guidance on staking.

Schwartz said he thought legislation held more promise for stakers hoping to see a change to the guidance.

“The IRS has had its say, and it appears from *Jarrett* that the IRS will do what it can to prevent a court from ruling on the question,” he said. “Accordingly, the only recourse for taxpayers now appears to be lobbying for legislation.”

(Updates with information on new court ruling in sixth paragraph.)

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