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COMMENTARY

*The IRS Offered to Refund Income Taxes Paid on Unsold Crypto
Staking Rewards*

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On February 2, 2022, the IRS announced it would refund \$3,293 to a Nashville couple who had paid that amount in taxes for Tezos tokens they had acquired through staking.¹ The couple, Joshua and Jessica Jarret, filed a lawsuit in May 2021 arguing that tokens acquired through staking should be considered property created by the taxpayer thus not taxable until they are sold.² Staking rewards are earned by locking one's cryptocurrency up in order to help validate transactions on the blockchain.³ Estimates show that the staking of cryptocurrencies resulted in fifteen billion dollars of staking rewards in 2021.⁴ As the nascent industry of cryptocurrencies continues to grow, the IRS's handling of the taxation of staking rewards will be an issue of significant importance.

In 2014, the IRS issued Notice 2014-21 which provides that cryptocurrencies are to be treated as property for federal tax purposes.⁵ While the notice discusses the tangentially related issue of cryptocurrency mining, the IRS has not yet issued official guidance on how tokens earned through staking should be treated for tax purposes. Because of this, the case brought by the Jarrets has garnered much attention from the crypto community. However, it is important to note that the IRS's offer of a refund to the Jarrets does not mean that other taxpayers can now stop paying taxes on their tokens earned through staking. The IRS did not

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¹ Kamran Rosen, *In Huge Precedent, IRS Refunds Income Taxed on Unsold, Staked Crypto*, FORBES (Apr. 3, 2022, 3:41 PM), <https://www.forbes.com/sites/kamranrosen/2022/02/02/in-huge-precedent-irs-says-it-will-not-tax-unsold-staked-crypto/?sh=2b220d10464c>.

² *Id.*

³ ETHEREUM, (Apr. 3, 2022, 3:58 PM), <https://ethereum.org/en/staking/#main-content>.

⁴ STAKED, (2021), <https://staking.staked.us/state-of-staking>.

⁵ IRS., Notice 2014-21 (2014), <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>

issue any additional guidance, they simply offered the individual taxpayers a refund.

The Jarrets rejected the IRS's offer because the IRS did not provide a reason as to why the refund was offered.⁶ The Jarrets hope that by continuing their lawsuit they can induce the IRS to issue new guidance regarding the taxation of staking rewards.⁷ Accordingly, the refund offered to the Jarrets should not be relied upon as a precedent by future taxpayers until official guidance is provided. Indeed, the 2021 IRS 1040 form instructions indicated that taxpayers should include as a transaction "[t]he receipt of new virtual currency as a result of mining and staking activities."⁸

If the IRS chooses to issue guidance stating that staking rewards are not taxable until the tokens are sold, it will have two strong policy reasons to support its decision. First, the taxation of unsold tokens earned through staking creates a potential liquidity issue for taxpayers. The receipt of new tokens does not provide a taxpayer with any cash to pay for the taxes incurred. Thus, the taxing of staking rewards forces taxpayers to raise the cash needed to pay the tax from other sources which may result in inefficient economic outcomes. Second, given that cryptocurrencies may decrease in value after the staking rewards are received, the IRS may be imposing taxes at values far above the actual value eventually received by the taxpayer.

The pending legal battles and the ultimate path the IRS decides to take in taxing staking rewards will have a large economic impact in the growing blockchain industry. Many blockchains, like Bitcoin, who do not utilize a proof-of-stake validation system will not be as concerned. However, individuals and corporations that are engaged in staking should keep a close eye on the outcome of this case and any other guidance the IRS may issue in the future.

⁶ Pallav Raghuvanshi & Shira Peleg, *A Recent Court Case Leaves Many Speculating on the Taxation of Staking Rewards*, NATIONAL LAW REVIEW (Apr. 3, 2022, 4:20 PM), <https://www.natlawreview.com/article/recent-court-case-leaves-many-speculating-taxation-staking-rewards>.

⁷ Cheyenne Ligon, *IRS Offers Tezos Staker Refund on Rewards Tax in Break From Current Policy*, COINDESK (Feb. 3, 2022), <https://www.coindesk.com/policy/2022/02/03/irs-offers-tezos-staker-refund-on-rewards-tax-in-break-from-current-policy/>.

⁸ IRS, 1040 Instructions (2021), <https://www.irs.gov/pub/irs-pdf/i1040gi.pdf>.