Navigating the Blockchain Landscape: Recent IRS Guidance on Convertible Virtual Currency and the Treasury's Continued Delay Regarding Broker Regulations

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This article explores recent developments in the U.S. federal taxation of virtual currencies by the Internal Revenue Service (IRS) and ongoing delays in broker regulations by the Department of Treasury. The IRS has issued recent guidance through Rev. Rul. 2023-14, which addresses the U.S. federal tax implications of receiving validation rewards via the "staking" mechanism in proof-of-stake cryptocurrencies. The foregoing ruling maintains the IRS's stance that convertible virtual currencies should be treated as property for federal tax purposes. This article examines the details of Rev. Rul. 2023-14, its implications for taxpayers, and the broader challenges in the evolving cryptocurrency landscape. Despite these developments, uncertainty persists, emphasizing the importance of staying informed and in compliance with IRS guidance.

Brief History of U.S. Federal Taxation of Virtual Currency

The IRS provided initial guidance regarding virtual currency transactions in a list of "Frequently Asked Questions" (FAQs) contained in IRS Notice 2014-21,[1] which generally stated that virtual currency transactions were to be treated the same as other property transactions with respect to gain, loss and cost basis under the Internal Revenue Code of 1986, as amended (the "Code").

By the end of August 2019, the IRS had sent at least 10,000 "educational" letters (i.e., warning letters) to taxpayers regarding their potential failure to report or pay tax on cryptocurrency transactions. The identity of the recipients of such educational letters allegedly arose from the information obtained by the IRS

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from the "John Doe" summons served on Coinbase, Inc., a cryptocurrency exchange that primarily dealt in Bitcoin transactions during the time period covered by the summons. The primary focus of the letters was to "educate" taxpayers who purportedly engaged in sales or exchanges of virtual currency; however, such letters also identified additional sources of taxable income and reporting requirements that could arise from cryptocurrency payments. The IRS published two additional FAQs on October 9, 2019, issued contemporaneously with Rev. Rul. 2019-24[2] shortly after distributing the above-noted educational letters. Although the IRS and the Department of Treasury indicated that greater guidance in the cryptocurrency area would be forthcoming, there has been little guidance until Rev. Rul. 2023-14.[3]

Rev. Rul. 2023-14: Staking and Tax Consequences

On July 31, 2023, the IRS issued Rev. Rul. 2023-14 addressing the U.S. federal tax consequences for a cash-basis taxpayer that receives validation rewards from participating in what is called "staking" cryptocurrency native to a proof-of-stake (PoS) rather than a proof-of work (PoW) mechanism to approve and corroborate transactions in the blockchain. Rev. Rul. 2023-14 follows the IRS' initial guidance with respect to virtual currencies, which means that convertible virtual currency is treated as "property" for U.S. federal income tax purposes; therefore, general U.S. federal tax principles applicable to property transactions also apply to convertible virtual currency transactions. The IRS unsurprisingly held in Rev. Rul. 2023-14 that the taxpayer was in receipt of gross income under Section 61 of the Code when the taxpayer has sufficient "dominion and control"[4] to "sell, exchange or otherwise dispose of"[5] the validation rewards.

The following is a simplified example of the timing of the recognition of gross income under Section 61 of the Code pursuant to Rev. Rul. 2023-14: Taxpayer owns 500 units of a cryptocurrency (referred to as "C") that is validated by PoS. Taxpayer then stakes 250 units of C in tax year 1 and validates a new block of transactions on the C blockchain for which the taxpayer will receive 5 units of C as a validation reward once the blockchain's protocols legitimize the

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taxpayer's transaction, which transpires in tax year 2. Therefore, the taxpayer has gross income under Section 61 of the Code in tax year 1 that will be equal to the fair market value of the 5 units of C since the taxpayer then has dominion and control over and the ability to sell, exchange or otherwise dispose of such units. The amount reported as gross income becomes the taxpayer's cost basis in the 5 units of C.

The Jarretts' Case and Legal Challenges

Rev. Ruling 2023-14 formalized the IRS' stance regarding an issue raised by Joshua and Jessica Jarrett (the "Jarretts") on September 30, 2022. The Jarretts filed a lawsuit in the U.S. District Court for the Middle District of Tennessee, Nashville Division,[6] petitioning the court with respect to a claim for a refund for income taxes of approximately $4,000 related to income recognized from staking. The Jarretts contended that the new Tezos tokens had been created by Joshua Jarrett from staking his Tezos tokens and computer power; therefore, the Tezos tokens should not be income in the tax year of creation, but rather deferred to the tax year when sold or exchanged, similar to self-sourced property such as harvesting crops or paintings. In a surprising move, the IRS sent a refund check to the Jarretts for the income taxes paid, plus interest, in an attempt to prevent litigation. The Jarretts wrote a letter to the IRS rejecting the refund and expressed their preference to litigate the issues until judgment. The district court dismissed the Jarretts' case as moot since the case law provides that the refund is paid upon the IRS' issuance of the refund check. On August 18, 2023, the U.S. Court of Appeals for the Sixth Circuit affirmed the district court's holding, citing Rev. Rul. 2023-14. [7]

Even though tax professionals are generally not surprised by the IRS' guidance in Rev. Rul. 2023-14 and both decisions in the Jarretts' case, the foregoing fails to provide the guidance that taxpayers and their tax professionals have been seeking, particularly with respect to the rapidly changing ways that crypto investors are using staking. Furthermore, many tax professionals have surmised that the above-noted will likely spawn further litigation with the IRS.

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Understanding PoS versus PoW Mechanisms

Decentralized finance (DeFi) networks must ensure that no parties are able to spend any cryptocurrency twice, to avoid duplicative spend, and without the involvement of either a third-party or any central authority, such as banks or FinTechs (PayPal, for example). The mechanism for DeFi transactions is a set of protocols (called a "consensus mechanism") by which the integrity of the blockchain is maintained by multiple validators who are then rewarded by additional units of the cryptocurrency native to the particular blockchain. The following is a brief and very simplified description of PoS versus PoW for those unfamiliar with these two main consensus mechanisms presently used to validate virtual currency transactions:

- Bitcoin, the first cryptocurrency, relied upon (and continues to rely upon) PoW to validate transactions in the Bitcoin network. Participants or "miners" compete to develop and correctly answer complex mathematical problems in order to be rewarded with additional Bitcoin. The most often cited disadvantage to PoW is the computer power necessary to mine additional Bitcoin, which requires the miners to incur massive energy costs.
- Staking:
    - Staking can be accomplished through centralized exchanges, such as Coinbase. For example, Ethereum, which is a blockchain network that supports its own native cryptocurrency (called Ether) and all other Ethereum-based tokens, began a separate chain or "fork" in late 2020 in order to precipitate what Ethereum called the "merge" from a PoW to a PoS validation mechanism. By September of 2022, Ethereum had successfully switched to PoS, which reduced Ethereum's power consumption by 99.95%.
    - Investors are also finding new ways in which staking can also be accomplished, such as through pools or delegated staking mechanisms where investors pool their tokens together and share the validation rewards.

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Since staking involves pledging cryptocurrency, the more the participant stakes, the greater the rewards. However, most investors that choose to stake cryptocurrency outside of a centralized exchange will lack the infrastructure and/or the ability to track and report the validation rewards since staking investors often receive rewards multiple times per day, with differing values during the day.

Treasury's Continued Delay Regarding Broker Regulations

In 2021, Congress passed the Investment in Infrastructure and Jobs Act that included an expansion of the reporting requirements for brokers of digital assets under Code Section 6045, with a deadline for issuance of such rules by December 31, 2023. In late 2022, the IRS issued transitional guidance in Announcement 2023-2, which stated that brokers may continue to report "as required under existing law and regulations as of December 31, 2022" until the final regulations are released. The key takeaway from Announcement 2023-2 was an extension of the effective date of the final regulations. Although the proposed rules were reviewed and released by the Office of Information and Regulatory Affairs in early 2023, the Department of Treasury issued the draft of the proposed regulations on August 25, 2023, which are subject to comments until October 30, 2023. A letter was sent to both agencies by Senators Elizabeth Warren (D-MA), Richard Blumenthal (D-CT), Bob Casey (D-PA) and Bernie Sanders (D-VT) requesting the release of the final regulations by the deadline imposed by Congress. Additionally, Senators Kirsten Gillibrand (D-NY) and Cynthia Lummis (R-WY) proposed a bill that includes a reversal of Rev. Rul. 2023-14.

Conclusion

As outlined above, the Treasury's and the IRS' inability to keep up with the quickly and ever-changing cryptocurrency landscape continues to pose significant challenges for both taxpayers and regulatory authorities. The recent Rev. Rul. 2023-14 provides much-

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needed guidance on staking rewards; however, uncertainties still persist, potentially leading to legal conflicts. With regards to staking, until further guidance has been provided by the IRS (or a legislative reversal occurs), the safest course of action for a taxpayer would be to follow the guidance in Rev. Rul. 2023-14.

For more information, please contact the author or any attorney in Frost Brown Todd's Tax and Blockchain teams. You can also visit our Tax Law Defined® Blog for more insight into the latest developments in federal, state, and local tax planning and tax administration.

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[1] See Notice 2014-21, 2014-16 I.R.B. 938, as modified by Rev. Rul 2019-24, 2019-44 I.R.B. 1004, and Notice 2023-34, 2023-19 I.R.B. 837.

[2] 2019-24 I.R.B. 1004.

[3] Rev. Rul. 2023-14, 2023-33 I.R.B. ___ (Aug. 14, 2023).

[4] Id.

[5] Id.

[6] Jarrett v. U.S., No. 3:21-cv-00419, 2022 BL 349876 (M.D. Tenn., Sept. 30, 2022)

[7] Jarrett v. U.S., No. 22-6023, 2023 BL 287792 (6th Cir. , Aug. 18, 2023)

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