

CRYPTO TAX SAFE HARBOR: ETF STAKING

Background

Treasury and the IRS have issued a safe harbor, in the form of Revenue Procedure 2025-31, under which a crypto exchange-traded product (commonly referred to as a crypto ETF, but more correctly described as a crypto ETP) can stake its digital assets without being taxed as a domestic corporation. The revenue procedure, while helpful, presents several questions and challenges. This alert provides our initial high-level reactions.

Crypto ETFs are structured as grantor trusts for US tax purposes. Grantor trusts are intended to be, effectively, custodial arrangements. If a crypto ETF qualifies as a grantor trust, it is not subject to entity-level tax, and US investors receive tax reporting on 1099s instead of K-1s (which apply to partners in a partnership).

If, instead, a crypto ETF is a “business entity,” or has managerial power over the trusted funds to take advantage of variations in the market, it likely would be treated as a “publicly traded partnership” taxed as a corporation. As such, it would be subject to U.S. federal income tax (at a 21% rate) on its net income, and its distributions generally would be taxed as dividends to certificateholders.

Before the revenue procedure, it was unclear whether a crypto ETF could stake its digital assets. Some tax advisors were concerned that, if the staking provider’s activities are imputed to the ETF under agency principles, the IRS would view staking to be a business activity of a type that jeopardizes the ETF’s grantor trust status. In addition, tax advisors questioned whether a crypto ETF could change staking providers to minimize service fees, exercise discretion in determining what software a staking provider uses or setting the software’s parameters, change the percentage of assets staked, or elect to compound rewards without manifesting an impermissible “power to vary.” (Spoiler: the safe harbor prohibits at least some of these actions.)

A small number of ETF sponsors have recently announced that their crypto ETFs have begun to stake their assets, but the above concerns have kept others at bay. Thus, the revenue procedure is a welcome development.

Safe Harbor

Very generally, under the revenue procedure, staking does not cause a crypto ETF to fail to be treated as a grantor trust if the following criteria are satisfied:

- Assets are staked through “one or more” professional staking providers unrelated to the sponsor in exchange for an arm’s-length fee (which may be a percentage of staking rewards). This requirement could be problematic for sponsors that own staking providers. In addition, it is unclear under the revenue procedure how often staking providers can be changed, if at all.
- The sponsor and custodian do not “participate in or direct or control the activities of the staking provider in any way,” other than by directing the provider to stake or unstake. This prohibition, on its face, is very broad. Sponsors might want to instruct staking providers on key matters, such as software selection and censorship of transactions by OFAC-sanctioned clients.
- All assets are staked at all times, except (i) to keep a liquidity reserve solely to comply with securities exchange requirements, (ii) on a temporary basis to pay expenses, effect creations or redemptions of interests, or hold new rewards, and (iii) by reason of specified extraordinary events.
- “To protect or conserve the trust’s property, the trust’s digital assets are indemnified from slashing due to the activities of staking providers.” This requirement might be challenging. Most staking providers indemnify for gross negligence, but the safe harbor seems to require a broader indemnity provision.
- The trust owns only one type of digital asset. The policy rationale for this requirement is not entirely clear, and it might be worth considering whether a single crypto ETF might be deemed to consist of two or more separate grantor trusts for tax purposes—for example, one that holds and stakes ETH and another that holds and stakes SOL. In addition, one (perhaps unintended) consequence of this requirement is that a crypto ETF that uses stablecoins instead of, or in addition to, cash apparently would not satisfy the safe harbor.
- At least quarterly, all staking rewards, net of expenses, are distributed or are sold for cash and the cash is distributed. This requirement is especially challenging. Many investors would prefer ETFs to compound staking rewards, and staking software often automates compounding. Moreover, some blockchain protocols do not enable immediate withdrawal of all earned staking rewards. Accordingly, sponsors will need to come up with “rough justice” methods for calculating and distributing staking rewards at least quarterly.

The paragraph that requires quarterly distributions also provides: “The trust treats all staking rewards consistently.” The meaning of this provision is unclear. It might mean crypto ETFs must treat all staking rewards as taxable income. Broadly, staking rewards typically consist of two components—(1) tokens newly minted by the relevant blockchain and (2) all or a portion of the transaction fees blockchain users pay for priority inclusion of their transactions. Some tax advisors believe the first component is not subject to tax, and instead is received with a zero basis, because it is not “realized” from a “source” other than the taxpayer’s own efforts. The tax law has never previously taxed the first owner of property, such as farmers who harvest crops or miners who extract ore from the earth, until a sale.

It might be worth considering whether a crypto ETF that holds liquid staking tokens (“LSTs”) would be subject to better tax treatment than a crypto ETF that relies on the revenue procedure. Broadly, LSTs are tokenized representations of staked digital assets. IRS Notice 2014-21 provides that virtual currencies (such as LSTs) are “property,” which suggests LSTs are not “looked through” to the activities or income. Accordingly, if a grantor trust holds only non-rebasing LSTs—that is, LSTs that do not increase in number, but instead are redeemable for a constantly increasing number of the underlying digital assets as staking rewards accrue—it arguably could take the position that its certificateholders have no taxable income until they sell or redeem their trust certificates. Taxpayers may rely on IRS notices until revoked. That said, there is no assurance the IRS would not revoke or modify Notice 2014-21 to require a LSTs to be looked through.

Amendments

The safe harbor lets a crypto ETF amend its trust agreement to authorize staking until August 10, 2026. The amendment would not be treated as a disqualifying “power to vary.” Somewhat oddly, however, the safe harbor does not apply to crypto ETFs that amended their trust agreements before November 10, 2025.

Unanswered Questions

The revenue procedure leaves open some important questions, including:

- IRAs and other tax-exempt entities are subject to tax on “unrelated business taxable income.” The revenue procedure explicitly declines to address whether staking income (including income earned through a crypto ETF) would be UBTI, although its conclusion that a grantor trust can engage in staking activities suggests that staking activities do not constitute a business.
- Foreigners are subject to US income tax on income “effectively connected” with a US trade or business. The revenue procedure explicitly declines to address whether staking income (including income earned through a crypto ETF) would subject foreigners to US income tax, although, again, its conclusion that a grantor trust can engage in staking activities suggests that staking activities do not constitute a business.
- Foreigners are subject to 30% US withholding tax on “US-source” income that is *not* connected with a US trade or business. The revenue procedure does not address whether staking income (including income earned through a crypto ETF) would subject foreigners to withholding tax. Accordingly, sponsors might wish to ensure staking providers conduct all activities offshore to mitigate withholding tax risk. Even then, it remains to be seen whether brokers and other paying agents will withhold on crypto ETF distributions out of an abundance of caution.
- U.S. individuals generally are not entitled to deduct investment management fees and other “miscellaneous itemized deductions.” Nevertheless, historically, many custodial staking providers have sent 1099s to customers that net out their fees, which results in an effective deduction. If a staking provider earns \$100 of staking rewards on behalf of a crypto ETF and retains \$5 of the rewards as a fee, it is unclear whether the crypto ETF’s 1099s will report \$95 of rewards (effectively deducting the staking provider’s fees) or \$100 of rewards and \$5 of nondeductible miscellaneous itemized deductions.

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If you have any questions about the issues addressed in this alert, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email authors Jason Schwartz (partner) at 202.862.8912 or jdschwartz@cahill.com and Chaim Herbstman (associate) at 202.862.8982 or CHerbstman@cahill.com.