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U.S. Federal Income Taxation of Staking Rewards

Cahill Gordon & Reindel LLP is pleased to submit this memorandum on the U.S. federal income tax treatment of staking rewards. Staking enables retail users and other digital asset holders to help secure blockchain networks. As staking is foundational to many networks and increasingly common among retail participants, getting the tax treatment of staking rewards right is essential to crafting coherent U.S. digital asset tax policy.

As explained in greater detail below, staking rewards consist of two components: (1) newly minted tokens programmatically produced by the open-source software that validators, or "stakers," run on their computers; and (2) fees paid to stakers by blockchain users for inclusion of their transactions on-chain. Revenue Ruling 2023-14 concludes that cash-method taxpayers (i.e., non-institutional and other non-business stakers) who "receive" staking rewards must include, as ordinary income, the fair market value of those rewards in the year in which they gain dominion and control over them.

Revenue Ruling 2023-14 is incorrect as applied to newly minted tokens. As described in greater detail below, "income," within the meaning of the tax law, requires a realization, or *coming in* from a *source*.[1] Consistent with that requirement, income tax has never previously been—and cannot legally be—imposed on a cash-method taxpayer's production of property, such as newly harvested crops, newly bred livestock, newly extracted minerals, newly created intellectual property, or newly manufactured goods.[2] The tax law refers to that property as "self-produced," or "self-created," property.[3]

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1 *See, e.g.*, Constitution, amendment XVI (authorizing Congress to tax "incomes, from whatever *source derived*") (emphasis added); I.R.C. § 61 (defining gross income as "income from whatever source *derived*") (emphasis added); *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (income requires a "coming in"); *Commissioner v. Glenshaw Glass*, 348 U.S. 426, 431 (1955) (income requires an accession to wealth, "clearly realized").

Except as otherwise specified, all section references herein are to the Internal Revenue Code of 1986, as amended (the **Code**), and Treasury regulations promulgated thereunder.

2 *See, e.g.*, *Tatum v. Commissioner*, 400 F.2d 242 (5th Cir. 1968) (harvesting crops); IRS Publication 225, "*Farmer's Tax Guide*," at 61 (grain harvesting and animal breeding); Revenue Ruling 86-24 (animal breeding); Revenue Ruling 77-176 (oil and gas extraction).

3 *Cf.* 26 C.F.R. §1.263A-1(c)(2) (for determining property "produced" by the taxpayer, "*[p]roduce* means construct, build, install, manufacture, develop, create, raise, or grow"); 26 C.F.R. § 1.197-2(d)(2) (a "self-created intangible" includes an intangible "to the extent the taxpayer makes payments or otherwise incurs costs for its creation, production, development, or improvement, whether the actual work is performed by the taxpayer or by another person under a contract with the taxpayer entered into before the contracted creation, production, development,

Newly minted tokens do not *come in* from another person; taxpayers produce them by running open-source (i.e., unowned) software on their computers. Those taxpayers are analogous to farmers vying to harvest fruit from unclaimed, common, or public property. Fees they receive from blockchain users for including transactions on-chain *are* taxable income, just like farming subsidies or other service payments; the fact that those fees are paid concurrently with the production of newly minted tokens does not cause newly minted tokens to be taxed at production, just as farming subsidies do not cause crops to be taxed at harvest.

Moreover, clear reflection of economic income is one of the tax law's guiding principles and underlies the realization requirement.[4] Taxing newly minted tokens at acquisition fails to reflect a staker's economic income because it taxes stakers before they have exited (or even *can* exit) their investment and ignores the dilutive effects of newly minted tokens.

Treasury and the Internal Revenue Service (the **IRS**) should amend Revenue Ruling 2023-14 to clarify that a taxpayer's acquisition of newly minted tokens is not income.

Part I of this memorandum provides factual background on staking. Part II describes how Revenue Ruling 2023-14 has created uncertainty among taxpayers by purporting to tax property production in a manner inconsistent with the history of the income tax. Part III explains why newly minted tokens are not income to non-business stakers. Part IV explains why treating the production of newly minted tokens as income results in a poor reflection of stakers' economic income. Part V distinguishes the production of newly minted tokens from amounts that historically have been treated as income. Part VI explains how Revenue Ruling 2023-14 can be modified to clarify that only the transaction fee component of staking rewards is income under current law.

I. Staking secures public blockchain networks, and newly minted tokens arise programmatically from that security function

Public blockchain networks are virtual ledgers maintained by multiple computers, or nodes, running open-source software.[5] Anyone can run one or more nodes without requiring permission from another person. Although each node acts independently in its own economic interest, the software's incentive structure—referred to as a consensus mechanism—is designed to result in the emergence of a canonical ledger, including network address ownership balances and transactions.

Many blockchain networks use a proof-of-stake consensus mechanism, which requires nodes to ante up, or stake, a material amount of the network's native token into the software. Nodes that stake the requisite amount are eligible to participate in two activities, collectively referred to as network validation: (1) proposing new blocks of data for inclusion in the ledger; and (2) voting on the validity of blocks proposed by other nodes. The network software programmatically selects nodes to propose or vote on blocks.

Nodes earn "rewards" for network validation. Very generally, those rewards consist of two components:

- *Transaction fees*. The software transfers, to the proposing validator, a portion of the fees paid by network users for inclusion of their transactions in the ledger.[6]

or improvement occurs").

4 *See Tootal Broadhurst Lee, infra* note 15.

5 Open-source means the software is free to use, modify, and distribute.

6 The network typically destroys, or burns, the fees not transferred to the proposing validator, which might wholly or partially offset the inflationary effects of block rewards.

- *Newly minted tokens*. The software programmatically mints new tokens to validators for proposing and voting on blocks of data to be added to the ledger. New token issuance is not dependent on or correlated with the amount of transaction fees paid by or received from users.

When a validator is selected to propose one or more blocks, the transaction fees the validator earns can be a significant part of their staking rewards for those blocks. However, because there can be only one block proposer at a time—whereas block voters typically represent all or a broad segment of active validators—validators spend most of their time voting on blocks, and only rarely are selected to propose new blocks. Accordingly, newly minted tokens represent the substantial majority of staking rewards a validator acquires over any extended period of time.

The requirement that nodes stake a material amount of a blockchain network's native token to validate helps to secure the network by ensuring that validators are economically aligned: a successful effort to attack the network by proposing or voting on invalid data blocks would reduce the value of the validator's own assets. In addition, some networks penalize validators that propose or vote on invalid blocks by destroying, or burning, all or a portion of their staked tokens.

To prevent rapid reductions of a network's economic security, and to ensure accountability for validator misbehavior, blockchain network software enforces a waiting period during which validators cannot withdraw their stake, which often includes all or a portion of staking rewards they have earned. The waiting period typically is dynamic, depending on the aggregate number of staked tokens seeking to exit, and can be significant.

Retail investors who want to participate in securing a blockchain network while acquiring staking rewards can run their own nodes from home, called "solo staking." However, retail investors might not have enough of a network's native currency to activate a node, and might not have the requisite hardware or technological wherewithal to maintain a node. Accordingly, many retail investors instead make their tokens available to a third-party service provider that runs a node on their behalf in exchange for a fee. Those investors continue to own their tokens at all times and, for tax purposes, generally are required to treat their share of any staking rewards as if they directly earned the rewards.[7] U.S. service providers are taxed at ordinary rates on any fees they earn for staking on behalf of a retail investor (including any fees paid by that retail investor in newly minted tokens), and this memorandum does not address service providers in their capacity as service providers.

II. Revenue Ruling 2023-14 treats the production of property as income, departing from longstanding income tax principles

Revenue Ruling 2023-14 addresses a hypothetical situation where a cash-method taxpayer "receives" cryptocurrency for validating blockchain transactions. The ruling concludes that the value of the cryptocurrency is ordinary income to the taxpayer when the taxpayer obtains "dominion and control" over that cryptocurrency, which is "the ability to sell, exchange, or otherwise dispose of" it, because, at that time, the taxpayer "has an accession to wealth." The ruling's statement of law lists service payments, gains from property dealings, rent, and royalties as analogous income types.

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[7] *See* Revenue Ruling 2023-14 (staking rewards are taxed the same whether earned directly or through a third-party service provider); *see also, e.g.*, *Commissioner v. San Carlos Milling Co., Ltd.*, 24 B.T.A. 1132 (1931) (a farmer's transfer of sugarcane to a refinery in exchange for warehouse receipts redeemable for a corresponding amount of refined sugar, less a paid-in-kind fee, was a bailment because the refinery "always had on hand sufficient sugar to cover outstanding warehouse receipts," even though it commingled cane juices from multiple farmers), *aff'd* 63 F.2d 153 (9th Cir. 1932); Revenue Ruling 65-218 (treating ownership of American Depositary Receipts as ownership of the underlying stock, even though ADRs do not reference specific stock certificates held by the ADR issuer).

A "loan" of tokens to a third-party staking business in exchange for a "fee" that is not determined by reference to the business's staking yield generally would not be treated as a bailment, so that the staking business's activities would not be imputed to the lender. *Cf. Provost v. United States*, 269 U.S. 443, 455 (1926) (broker becomes the owner of securities on loan where the broker has the ability to dispose of the securities). This memorandum does not address token loans.

The ruling does not distinguish between the two components of staking rewards—transaction fees and newly minted tokens—and its use of the term "receives" suggests that Treasury and the IRS view both components as payments by a person, notwithstanding the reality that only transaction fees are *received* from a person and newly minted tokens are produced by stakers running open-source software on their computers (and are not *received* from any person). Treasury officials have informally advised that the ruling's conclusion is intended to apply to both components of staking rewards.

If that informal advice is correct, then it would be the first time in the history of the income tax that the first owner of a commodity is taxed on the value of that commodity on acquisition, even if the owner is a cash-method taxpayer. As discussed below in Part III, newly harvested crops, newly bred livestock, newly extracted minerals, newly created intellectual property, newly manufactured goods, and other self-produced property might all be "accessions to wealth," but they are not *income* that is *derived* from a *source*, and so their production is not taxed. The analogies posited in the revenue ruling are distinguishable from newly minted tokens in that they involve a payment by *another person*, the property's previous owner—an employer, property buyer, landlord, or licensor.

Revenue Ruling 2023-14 has created uncertainty among taxpayers. Some taxpayers appropriately treat the production of newly minted tokens as nontaxable.[8] Others treat it as taxable but have different approaches to determining when they have obtained dominion and control. As mentioned above, blockchain network software enforces a waiting period during which validators cannot withdraw their stake, which often includes all or a portion of their newly minted tokens. Does a taxpayer have "the ability to sell, exchange, or otherwise dispose of" tokens that would, if a withdrawal process were activated, need to first sit idly and nontransferable in a long exit queue?[9] Analogous questions—the precise timing of a harvest, or when a manufactured good comes into being—do not need to be answered for other commodity producers, because those producers are taxed only at sale, not acquisition.

III. Newly minted tokens are not "income" because their creation does not involve a realization or a source

The Constitution's "apportionment clauses" limit Congress's ability to impose property taxes.[10] However, the Sixteenth Amendment authorizes Congress to tax "incomes, from whatever source derived."[11] The Code, in turn, defines gross income as "all income from whatever source derived."[12]

By their terms, each of the Sixteenth Amendment and the Code requires *income* to be *derived* from a *source*. In *Eisner v. Macomber*, the Supreme Court interpreted that language to precondition income taxation on a realization, or

8 Revenue rulings are not binding on taxpayers or the courts.

9 While the ruling concludes that a staker is not taxed until the end of "a brief period" during which the staker "lacks the ability to sell, exchange, or otherwise dispose of" their tokens, it does not address the more realistic scenario where a staker has the ability to activate a withdrawal, but the withdrawal process requires tokens to sit idly for a period of time.

10 *See* Constitution, article I, section 2, clause 3 ("Direct Taxes shall be apportioned among the several States…according to their respective Numbers."); Constitution, article I, section 9, clause 4 ("No capitation, or other direct Tax, shall be laid, unless in proportion to the Census or Enumeration herein before directed to be taken.").

11 Constitution, amendment XVI.

12 Section 61.

coming in.[13] In *Commissioner v. Glenshaw Glass*, the Court elaborated by defining income as "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[14]

Thus, by itself, an accession to wealth is not income; there also must be some realization event, a *derivation* from a *source*, such as a payment from, or exchange with, a person. As the Second Circuit explained in 1929, "[w]here the same organization makes and sells, the income is earned only upon the sale, and the prior increment flowing from manufacture is not income," because there is no way of calculating the amount of profit "until a sale be realized and the price becomes known."[15] Harvesting crops, breeding livestock, extracting minerals from the earth, producing art, cooking one's own dinner, and manufacturing goods might be accessions to wealth, but are not income derived from a source within the meaning of the Sixteenth Amendment or the Code.[16] Taxing their production would amount to a property tax in contravention of the Constitution's apportionment clauses.

A corollary is that the term "source" must mean a "person" who is not the taxpayer.[17] Otherwise, self-produced property *would be* derived from a source—e.g., the harvested field, mined quarry, or assembly line. Section 7701(a)(1) of the Code defines the term "person" to mean an individual, trust, estate, partnership, association, company, or corporation. Persons do not include one's own property (such as land, livestock, or raw materials). Persons also do not include unclaimed, common, or public property, even if someone has previously improved it. Thus, for example, the planting of crops by visitors on unclaimed, common, or public property does not cause a subsequent harvest of those crops to be taxable, and the integration of open-source intellectual property into a new work does not cause the creation of that work to be taxable income.

Public blockchain networks are virtual ledgers that emerge as a result of multiple nodes running open-source software. Open-source software is not a person under section 7701(a)(1) of the Code, and the amount of newly minted tokens produced by a validator does not correspond to transaction fees paid by network users. Thus, validators do not *derive* newly minted tokens from a *source* within the meaning of the Sixteenth Amendment or the Code; instead, their computers mint those tokens to their virtual accounts by running the open-source software. In substance, validators are digital farmers vying to pick fruit from trees planted on unclaimed, common, or public property.

Validators may occasionally earn transaction fees for proposing transactions. Those transaction fees are appropriately taxed as income to validators under current law because they are compensation paid by network users. However, a validator's receipt of transaction fees does not transform their self-produced property into compensation any more than a farmer's receipt of farming subsidies transforms the fruit they harvest into compensation. Instead,

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13 252 U.S. 189, 207 (1920) (income requires "*not* a gain *accruing* to capital; not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being '*derived*'—that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal—*that* is income derived from property") (emphases in original); *see also Palmer v. Commissioner*, 302 U.S. 63, 68 (1937) ("[O]ne does not subject himself to income tax by the mere purchase of property, even if at less than its true value, and…taxable gain does not accrue to him before he sells or otherwise disposes of it.").

14 348 U.S. 426, 431 (1955).

15 *Tootal Broadhurst Lee Co. v. Commissioner*, 30 F.2d 239, 240-41 (2d Cir. 1929).

16 *See* note 2, *supra*.

17 *Cf.* section 61 (providing an illustrative list of gross income items, all of which are derived from a person); *see, e.g.*, *Beard v. Commissioner*, 82 T.C. 766 (1984) ("wages, salaries, tips, etc." were amounts received from another person for services, and includable in gross income); *Deputy v. du Pont*, 308 U.S. 488, 497 (1940) (interest was compensation paid by another person for the use or forbearance of money); *Thompson v. Commissioner*, 17 B.T.A. 987 (Oct. 17, 1929) (rent was an amount paid for another person's use and enjoyment of tangible property); *Sierra Club Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996) (royalty was an amount paid to permit another person to use intangible property).

the validator realizes ordinary income in respect of transaction fees and does not realize any income in respect of newly minted tokens until a taxable disposition of those tokens.[18]

IV. Taxing newly minted tokens at production systematically overstates stakers' economic income

Clear reflection of economic income is one of the tax law's foundational principles, and is inherent in the income tax law's realization requirement.[19] As the Second Circuit explained in *Tootal Bradhurst Lee Co. v. Commissioner*, the realization requirement is a necessary predicate to taxing income because "many intervening factors may determine the loss or gain," including "deterioration or destruction of the product" and "the rule of supply and demand."[20] Thus, a tax cannot be imposed on *income*, instead of *property*, unless income can be accurately measured.

Taxing newly minted tokens at production does not accurately reflect a validator's economic profit because it (a) requires stakers to include income while they remain exposed to price volatility, often even before being able to withdraw from their investment, and (b) ignores the dilutive effects of newly minted tokens. It is analogous to taxing any other commodity at production by ignoring the potential "deterioration or destruction of the product" and "the rule of supply and demand."

a. Taxing newly minted tokens at production ignores stakers' continued economic risk

Taxing newly minted tokens on acquisition ignores the taxpayer's continued economic risk in the relevant blockchain network. Just as the manufacturer in *Tootal Bradhurst Lee* remained subject to price volatility on their product until selling it (and was not taxed until the sale),[21] stakers remain subject to price volatility on the tokens they produce until selling them.

Even worse, as explained above, validators need to keep a material amount of the blockchain network's native token locked up to continue running a node. During the lockup, they remain subject not only to price volatility but also potentially to slashing risk. Blockchain network software enforces a waiting period during which validators cannot withdraw their stake, and Treasury and the IRS apparently believe that a taxpayer is taxed on newly minted tokens when the taxpayer *can, theoretically*, queue those tokens for withdrawal—even if the taxpayer has not done so.[22] As a result, under Revenue Ruling 2023-14, taxpayers often must pay tax on newly minted tokens well before they can even sell them.

Taxing the production of newly minted tokens therefore ignores the potential "deterioration or destruction of the product" that militates against taxing the production of other commodities. Even outside of the context of self-

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18 Because newly minted tokens are not income, authorities that characterize income streams according to their "predominant character" are inapposite. *See, e.g.*, 26 C.F.R. § 1.954-1(e)(3). However, as mentioned above, newly minted tokens represent the substantial majority of staking rewards a validator acquires over any extended period of time (and, for many blocks, are the *only* component the validator acquires); accordingly, even if staking rewards *were* characterized according to their predominant character, that character would be self-produced property.

19 *See Tootal Broadhurst Lee*, *supra* note 15; section 446(b) (taxpayer's method of accounting must "clearly reflect income").

20 *See Tootal Broadhurst Lee*, *supra* note 15.

21 *Id.*

22 *See* note 9, *supra*; Revenue Ruling 2019-24 (a taxpayer has dominion and control over digital assets when they have "the ability to transfer" them); Revenue Procedure 2025-31 (generally requiring exchange-traded products structured as grantor trusts that stake their digital assets to treat "all rewards consistently").

produced property, the tax law does not treat option premiums or upfront payments on forward contracts as income to the recipient because it is "impossible to tell…whether they would ultimately represent income."[23]

b. Protocol-level inflation dilutes token value without creating new wealth

Newly minted tokens often are inflationary in nature and therefore do not entirely represent economic income. To provide a simplified example, assume Jack holds 300 and Jill holds 100 of a blockchain network's 400 native tokens at the beginning of the year, and Jack produces another 100 newly minted tokens over the course of the year through validation activities while Jill's token ownership remains constant. Assume further that the network's market capitalization remains static at $400 throughout the year, so that each token's value is $1 at the beginning of the year (that is, 400 tokens outstanding at a $400 market capitalization) and $0.80 at the end of the year (that is, 500 tokens outstanding at a $400 market capitalization).

By the end of the year, the aggregate value of Jack's tokens will have increased from $300 to $320 because he now owns four-fifths of tokens whose market capitalization is $400. But if Jack produces the 100 newly minted tokens ratably over the course of the year and the token price decreases linearly from $1.00 to $0.80, he will be taxed on approximately $90 instead of $20 under the conclusion in Revenue Ruling 2023-14.

Taxing the production of newly minted tokens therefore ignores "the rule of supply and demand" that militates against taxing the production of other commodities. The amount of overtaxation increases when staking participation rates are high, so that, if all of a protocol's tokens are staked, newly minted tokens are closely analogous to *pro rata* stock dividends in that they do not shift any value from one person to another. The Supreme Court held, in *Eisner v. Macomber*, that *pro rata* stock dividends are not income at all.[24]

Many blockchains feature a high level of staking participation. For example, Solana's staking participation currently is around 69%.

V. Newly minted tokens do not resemble any category of income recognized under the Internal Revenue

As mentioned above, Revenue Ruling 2023-14 suggests that the production of newly minted tokens is analogous to the receipt of service payments, gains from property dealings, rents, and royalties. Other commentators have likened the production of newly minted tokens to the receipt of interest, the receipt of property in a barter exchange, the receipt of non-pro-rata stock dividends, or the discovery of treasure trove.

As discussed below, all of those analogies are inappropriate because they involve a transfer of property from *another person* to the taxpayer, and therefore are *income* that is *derived from* a *source*.

a. Newly minted tokens are not compensation for services because no person pays them

Section 61 of the Code authorizes Congress to tax, as income, "compensation for services, including fees, commissions, fringe benefits, and similar items."[25] The Code does not define "compensation for services," but the

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[23] *See Virginia Iron Coal & Coke Co. v. Commissioner*, 37 B.T.A. 195, 198, *aff'd*, 99 F.2d 919 (4th Cir. 1938), *cert. denied*, 307 U.S. 630 (1939); Revenue Ruling 58-234 ("Since the optionor assumes [an] obligation, which may be burdensome and is continuing until the option is terminated, without exercise, or otherwise, there is no closed transaction nor ascertainable income or gain realized by an optionor upon mere receipt of a premium for granting such an option."); Revenue Ruling 78-182 (option premium not taxed until transaction is closed); Revenue Ruling 2003-7 (upfront payment under a variable prepaid forward contract not taxed until the contract is closed).

[24] 252 U.S. 189 (1920); *see also* section 305(a) (gross income does not include *pro rata* stock dividends).

[25] Section 61(a)(1).

term necessarily requires a payment to the taxpayer by another *person*. A contrary conclusion would characterize the production of property as a service payment in contravention of the history of the income tax.

Newly minted tokens are not paid by a person; they are produced by stakers running open-source software. As explained above, transaction fees received by stakers for including users' transactions on-chain *are* compensation for services and are taxable as income. However, stakers' receipt of those fees does not cause their production of newly minted tokens to be compensation for services, just as farming subsidies do not cause a corresponding harvest to be compensation for services.

In 2022, the New York State Bar Association Tax Section posited, in a report on the taxation of digital assets (the NYSBA Report), that newly minted tokens might be analogous to assets received in a "barter exchange" from blockchain users for securing the integrity of the blockchain.[26] That analogy is inconsistent with economic reality: blockchain users *do* pay transaction fees to stakers, and those transaction fees are compensation income; however, blockchain users *do not* pay newly minted tokens to stakers, and the issuance of newly minted tokens is not dependent on or correlated with the amount of transaction fees paid by or received from users. Moreover, if the production of newly minted tokens were compensation paid by blockchain users, businesses generally would be entitled to a deduction for the amount of the compensation.[27] The IRS has never suggested that any blockchain users are entitled to a deduction for the issuance of newly minted tokens.

The NYSBA Report also suggests that newly minted tokens might be qualitatively different from other types of self-produced property because they are produced using a software protocol created by other persons and analogizes newly minted tokens instead to diamonds printed by a fictional machine created by another person in exchange for periodic maintenance.[28] That analogy just begs the question of *whose* machine it is. It is uncontroversial that, if a machine owner permits a taxpayer to use the machine in exchange for repairing it, the value of the use is compensation to the taxpayer. But if the owner, instead, open-sources the machine, allowing people to take turns using it, no one is taxed on the value of that use or on the value of the machine's output to them.

Stakers run open-source software to produce newly minted tokens. No one owns that software, and no one is paying stakers newly minted tokens to repair the software.

b. Newly minted tokens are not dividends because they are not derived from a taxable entity's earnings or profits

Section 61 of the Code also authorizes Congress to tax dividends as income. Pro rata stock dividends are not income,[29] but cash dividends and non-pro-rata stock dividends are.

Dividends are distributions out of a corporation's earnings and profits.[30] Open-source validation software is not a corporation or other tax person.[31]

Blockchain network software also does not have earnings and profits. The total number of the network's outstanding tokens might change by reason of the software's programmatic operations, but that change is not reflective of any

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26 New York State Bar Association, *Report on Cryptocurrency and Other Fungible Digital Assets* at 46 (April 18, 2022), *available at* https://nysba.org/wp-content/uploads/2022/04/1461-Report-on-Cryptocurrency-and-Other-Fungible-Digital-Assets.pdf?srsltid=AfmBOopJjkfdALZVZAt18h8Xwt1BltzZsiuU-O3Bam1RDJ42SGc-zXn3.

27 *See* section 162.

28 *See* NYSBA Report at 47.

29 As mentioned above, many blockchains feature a high level of staking participation.

30 Section 316.

31 *See* section 7701(a)(1).

claim on assets by token holders. Corporate distributions that are not attributable to earnings and profits are a nontaxable return of capital up to a taxpayer's basis in their shares.[32]

c. Staking does not generate interest, rent, or royalties because it is not compensation for the use of money or property

Section 61 of the Code also authorizes Congress to tax interest, rent, and royalties.[33] Interest is compensation for the use or forbearance of money,[34] and rent and royalties are compensation for the use of property.[35] At least one commentator has analogized the production of newly minted tokens to interest on a deposit, since staking "is akin to lending or depositing the tokens in the network for the purpose of maintaining the network."[36] Similarly, Revenue Ruling 2023-14 analogizes newly minted tokens to rent or royalties.

As discussed above, open-source validation software is not a person under section 7701 of the Code. Because a taxpayer cannot pay interest, rent, or royalties to themselves, each analogy would necessitate a legislative change to treat open-source validation software as a person.

In addition, each analogy would require the adoption of a fiction whereby open-source software is treated as compensating stakers for locking up their tokens. That fiction would be inconsistent with economic reality. Stakers produce newly minted tokens by proposing or voting on blocks of data for inclusion on-chain. Locking up tokens is a predicate to being able to propose or vote, but stakers are not compensated for locking up tokens, just as a farmer is not compensated for dedicating (or "locking up") land for cultivation. Harvested crops are not interest, rent, or royalties on land.

d. Treasure troves and other awards apply only when property is transferred from another owner

Finders of lost or abandoned property (treasure trove) are taxed on its value when they reduce it to their "undisputed possession."[37] Similarly, prizes and awards generally are included in income.[38]

The taxation of treasure trove in the hands of its finder is entirely consistent with the principle that income requires a *coming in*. When someone finds treasure trove and reduces it to "undisputed possession"—for example, because the original owner does not emerge to claim it—ownership transfers *from* the original owner *to* the finder, resulting in a *coming in* from a source.[39] Similarly, prizes and awards are, necessarily, transferred from one person to another.

At least one commentator has mistaken the taxation of treasure trove, prizes, and awards as standing for the proposition that only persons "in the business" of producing property can "defer" income until sale, whereas "lucky

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32 *See* section 301(c)(2).

33 Section 61(a)(4)-(6).

34 *See Deputy v. du Pont*, 308 U.S. 488, 497 (1940).

35 *Thompson v. Commissioner*, 17 B.T.A. 987 (Oct. 17, 1929) (rent); *Sierra Club Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996) (royalties)

36 *See* Reuven Avi-Yonah and Mohanad Salaimi, *A New Framework for Taxing Cryptocurrencies*, The Tax Lawyer, Vol. 77, No. 1, at 37 (Fall 2023).

37 26 C.F.R. § 1.61-14(a).

38 Section 74.

39 *See Cesarini v. United States*, 296 F.Supp 3, 7 (N.D. Ohio 1969) (because "title belongs to the finder as against all the world except the true owner," finding property triggers a tax when the true owner does not emerge to dispute the finder's ownership, because only then has the property been "reduced to undisputed possession").

finds of treasure troves are included in income."[40] That proposition is patently wrong. When cash-method taxpayers—whether as amateurs or in a business—pick fruit, compose art, create widgets, or engage in any other property production, income is not "deferred," because *they do not have income*. Moreover, the amount of luck or effort involved in acquiring property is irrelevant to whether that acquisition is income; a taxpayer might toil for days with a metal detector to find a rare coin or might write a simple prompt to an open-source AI bot and produce a poem; only the rare coin is taxable income at acquisition, even if the poem can be monetized.

V. Revenue Ruling 2023-14 should be modified to tax user-paid transaction fees while excluding newly minted tokens

As mentioned above, Revenue Ruling 2023-14 concludes that cash-method taxpayers who "receive" staking rewards must include, as ordinary income, the fair market value of those rewards in the year in which they gain dominion and control over them, because they have an accession to wealth at that time.

Revenue Ruling 2023-14 does not distinguish between staking rewards that are transaction fees and those that are newly minted tokens. In addition, although it concludes that cash-method taxpayers have an accession to wealth when they obtain dominion and control over staking rewards, it does not address whether the taxpayers have "realized" income at that time, within the meaning of *Eisner v. Macomber* and *Commissioner v. Glenshaw Glass*.

In light of the discussion above, Treasury and the IRS should issue a new revenue ruling (1) clarifying that Revenue Ruling 2023-14 addresses only tokens "received" from blockchain network users as transaction fees, and does not address newly minted tokens, and (2) confirming that a validator does not realize income on the acquisition of newly minted tokens.[41]

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We appreciate your consideration of our analysis and recommendations. If you have any questions or comments regarding this memorandum, please feel free to contact us.

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[40] *See* Omri Y. Marian, *Law, Policy, and the Taxation of Block Rewards*, 175 Tax Notes Federal 1493 (2022).

[41] Because the discussion of newly minted tokens on a proof-of-stake blockchain network would apply equally to newly minted tokens on a proof-of-work blockchain network, such as Bitcoin, Treasury and the IRS also should modify the answers to questions 8 and 9 in Notice 2014-21 in a manner consistent with the new revenue ruling.