Proof of Stake—What's Really at Stake on the Tax Front?

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Growing investment and recent tax developments have generated increased interest in cryptocurrency staking. In this article, K. Peter Ritter and Joshua S. Tompkins provide a general overview of staking, describing what it is, what it is not, and the various staking methodologies commonly employed. The authors then consider the different potential tax characterizations of staking and the general U.S. federal income tax consequences under each alternative. Lastly, they provide several considerations for special classes of investors, such as foreign and U.S. tax-exempt investors.

I. Introduction

In a proof-of-stake ("PoS") consensus mechanism, "stakers" maintain the integrity of the blockchain by locking up or "staking" the blockchain's native cryptocurrency. In exchange for doing so, the staker receives "staking rewards" paid in additional units or "coins" of the blockchain's native currency. The ability to generate yield in a relatively passive manner has engendered significant interest from the cryptocurrency and investment communities and, as of the time of writing, there was over $35 billion staked on the Ethereum consensus layer alone.[1]

The interest around staking has been further heightened by a recent well-publicized tax case brought by taxpayers seeking a refund from the Internal Revenue Service ("IRS"), as well as by a recent IRS news release.[2] These developments have not only increased the interest around staking but also have underscored the tax uncertainty associated with this new and unique technology. Given this uncertainty, taxpayers would be well advised to consider the possible U.S. federal income tax consequences prior to engaging in staking activities.

This article is arranged as follows: Part One provides a general overview of staking, describing what it is, what it is not, and the various staking methodologies commonly employed. Part Two describes the general U.S. federal income tax considerations of staking, such as the time at which income is recognized and the character of such income. Part Three describes the U.S. federal income tax issues for foreign investors and the potential characterization of staking in that context. Finally, Part Four describes the U.S. federal income tax framework applicable to

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otherwise tax-exempt entities and evaluates how staking income is likely to be treated in that context.

II. Part One: Background

A. Blockchain Consensus Models

Many believe that bitcoin was the first form of digital cash. Not so. Prior to bitcoin, there were many failed attempts to create digital currency.[3] Bitcoin succeeded where the others did not because it is decentralized, which is made possible by the groundbreaking consensus mechanism known as proof of work ("PoW"). Elegantly simple in its design, PoW prevents various types of "attacks" while simultaneously creating an accurate record of ownership.[4] For this reason, a PoW system has been employed in other blockchains, such as the Ethereum execution layer.[5]

PoW operates using a "peer-to-peer" model that is decentralized in the sense that no single company or person operates the network. Instead, so-called "blockchain" technology, which is sometimes referred to as distributed electronic ledger technology, enables this peer-to-peer model to function. Whenever a given cryptocurrency transaction occurs, it is first broadcast to its network so as to be verified or validated. Validation occurs using cryptography (that is, encryption and decryption). Once confirmed, each transaction is then recorded with other transactions in a "block" of computer code and is then added and linked to previous blocks to form a chain—hence, the term "blockchain." The updated ledger is then distributed across the network, such that all computers on the network are constantly verifying that the blockchain is accurate. In a PoW consensus process, "miners" compete with each other to solve a cryptographic puzzle. The winning miner is given the right to create a new block that is then broadcast to the network and is rewarded with newly minted/created cryptocurrency and, in some cases, also a portion of transaction fees.[6]

Although PoW was a groundbreaking technology, it is not without its drawbacks. Competition between miners to win the right to create the next block and receive the associated rewards had led to a hash rate "arms race" where miners invest in ever-increasing amounts of computational power. The economic utility of these expenditures has been questioned. This dynamic has also had the effect of centralizing mining power (and network control) in the hands of relatively few large-scale professional miners. Mining is also very energy intensive and therefore has a negative effect on the environment.[7] Lastly, the costs associated with the mining process and the limits on throughput often result in relatively high transaction fees, a result that reduces the utility of the blockchain for everyday transactions.[8]

To address some of these perceived shortcomings, a new consensus mechanism—PoS—was created. Under a PoS consensus process, "validators" lock-up—("stake")—the blockchain's native cryptocurrency and receive rewards (paid in the blockchain's native cryptocurrency) when they create new blocks or validate blocks created by other validators. In most PoS systems, validators are chosen at random to create blocks and are responsible for checking and confirming blocks they don't create. Although validator selection is random, the chances of being selected generally increase with the size of the stake, much like a weighted lottery. If the selected validator successfully verifies a given transaction or creates a new block, then the network updates the blockchain and staking rewards are awarded to the validator (and potentially delegators, as described below).

When compared to PoW, PoS boasts of several advantages, including faster transaction times, reduced fees, and increased throughput. The ability to generate additional yield through staking is also attractive. Also, because validators are selected based on the size of a stake rather than computing power, a PoS system eliminates the need for expensive computers and large amounts of energy consumption. This makes it more environmentally friendly and should (at least in theory) make the system more decentralized by allowing everyday users to validate without expensive hardware.[9]

But, PoS has its own downsides. First, PoS systems are significantly more complex than PoW.[10] Second, the reward system with PoS can be punitive as compared to PoW. In particular, in a PoW system there is no need to "punish" bad miners that try to validate the wrong chain or make invalid blocks that do not fit the rules of the network. Those miners will not receive rewards, such that their "punishment" is simply the fact that they spent real-world resources (*e.g.*, electricity costs) and did not generate a return. A PoS system does not have this same connection to real-world resources and therefore needs a way to discourage stakers from improperly voting on the wrong chain. The punishment system in a PoS consensus process is known as "slashing." If stakers are "slashed" because they let their computers go offline or validate a "bad" block of transactions, then they will lose some or all of their stake.

As noted, PoS is most commonly associated with the Ethereum consensus layer.[11] However, other significant cryptocurrencies use a PoS model, including Solana[12] (the third largest non-stablecoin cryptocurrency by market capitalization) and Tezos[13] (the blockchain that was involved in the *Jarrett* case, discussed below). It is important to understand that there are significant differences between the PoS systems employed by these blockchains (and others), given that these differences could affect the tax treatment of staking transactions.

B. Staking Rewards Systems

One key area of distinction is the reward schemes employed by various blockchains.

On Ethereum, users are required to pay a fee (commonly referred to as "gas") in connection with each transaction. This fee can have two components—a "base fee" and a "priority fee."[14] The base fee is always required to be paid and the amount of the base fee is determined by the network. The priority fee is an optional fee that users can pay to speed up their transaction. Base fees are destroyed or "burned" and priority fees are transferred to validators. In addition to priority fees, validators also receive newly created ether ("ETH").[15] The Ethereum fee structure can be inflationary or deflationary, depending on the relationship between the amount of newly created ETH and the amount of ETH being burned as transaction fees.

On the Solana blockchain, however, users are charged a transaction fee for each transaction, half of which is transferred to validators and half of which is burned.[16] In addition to transaction fees, validators are also rewarded with new SOL tokens ("SOL"), which are created pursuant to a predetermined issuance schedule. The SOL issuance schedule is disinflationary in that the inflation rate decreases over time until it reaches a long-term inflation rate of 1.5 percent.[17] Whether Solana is net inflationary or deflationary depends on the amount of transaction fees and where the blockchain is on its issuance schedule.

On the Tezos blockchain, users are charged a transaction fee for each transaction, which is transferred to validators.[18] In addition to receiving transaction fees, validators are also rewarded with new tez ("XTZ"), which is created at a rate of 42 million XTZ per year. Because transaction fees are not burned, if a XTZ holder does not stake their XTZ, their proportionate interest in the network will be diluted over time (*i.e.*, the Tezos blockchain is "inflationary").

C. Staking Methods—Direct, Delegated, Custodial, and Liquid

In a PoS system, the number of transactions a network can handle can be increased if the network is willing to require that validators comply with rigorous hardware and technical requirements. Stringent requirements create a barrier to entry and tend to reduce the number of validators. Thus, there is a tradeoff between speed/scalability and decentralization. Different blockchains have taken different approaches when managing this tradeoff. For example, on the Ethereum consensus layer, hardware requirements are minimal, and users can validate, themselves, directly by using only a laptop computer (*i.e.*, self-stake).[19] On Solana, the technical and hardware requirements create a significantly higher barrier to entry. Thus, although anyone can technically participate in a PoS network as a validator, self-staking is practically out of reach for many casual investors.

As an alternative to self-staking, users can stake by delegating their cryptocurrency to others who perform the actual validation function on their behalf. Generally, delegation is noncustodial and therefore does not result in a transfer of the staked cryptocurrency to the validator. In this noncustodial delegated staking scenario, staking rewards are split between the validator and the delegating staker by the blockchain itself. That is, no part of the staking reward paid to the delegating staker comes from the validator.

Another potential option, however, is custodial staking. In custodial staking, users transfer custody of their cryptocurrency to a third-party and allows that third-party to stake their cryptocurrency. The third-party validator then receives the rewards and shares a portion of the rewards with the staker (usually, a fixed return). In this scenario, the rewards payments can come from the third-party validator (and not the blockchain), because the validator is, in the eyes of the blockchain, the owner of the cryptocurrency being staked and therefore entitled to the full staking reward. This approach is often employed by exchanges, such as Coinbase, that hold custody to one's cryptocurrency.

The last approach to staking is liquid staking. In liquid staking, users transfer their cryptocurrency to a platform that stakes the cryptocurrency. In exchange, users receive a transferrable wrapped version of the staked token that is freely transferrable. The downside to this approach is that the third-party, rather than the user, selects the validators to whom the underlying currency will be delegated to (*i.e.*, there is some loss of control). However, the benefit to this solution over the others is that the wrapped token is transferrable and can therefore be used in decentralized finance ("DeFi") transactions, while at the same time generating staking rewards.

D. Staking vs Yield Farming vs Liquidity Mining

It should be noted that staking is not the same as yield farming or liquidity mining, and the differences are worth noting for the sake of clarity. At its core, yield farming involves lending cryptocurrency for a fee *via* a DeFi network. Similar to loans of fiat currency that generate interest, holders of cryptocurrency that would otherwise be holding it "dormant" in an exchange or wallet can lend out their holdings *via* liquidity pools[20] for an economic return. That return comes in the form of fees (*i.e.*, tokens or interest) generated from the pool. Liquidity mining is essentially the same as yield farming, but in liquidity mining the participants earn governance tokens[21] native to the platform.[22]

III. Part Two: General U.S. Federal Income Tax Issues

For investors engaged in staking, the primary U.S. federal income tax issues are: (i) the time at which staking rewards should be included in taxable income, (ii) the character of such income, (iii) whether staking activities can give rise to a trade or business, and (iv) whether staking activities could give rise to a deemed partnership. These inter-related issues are considered in this section of the article.

A few caveats are warranted. Unless specifically indicated, the discussion that follows is not specific to any particular blockchain and the differences between different blockchains may warrant disparate tax characterizations in some cases. Also, the focus herein is solely with respect to self-staking and delegated staking. The tax consequences of custodial staking and liquid staking could be materially different.[23] It should also be noted that in many cases the tax treatment of staking transactions depends to a significant degree on facts and circumstances that are particular to each taxpayer. Accordingly, this article is inherently general in nature, limited in scope, and is not a substitute for consultation with a qualified tax advisor.

A. Timing

The IRS is of the view that a PoW mining reward constitutes gross income, equal to its fair market value, when received.[24] However, for staking activities, there is no official IRS guidance as to the timing of when staking rewards are subject to taxation.[25]

When the economic returns from staking activities should be recognized into income likely depends on how a staking transaction is characterized. The tax positions taken on this issue generally fall into two broad categories, which are referred to herein as the "self-created property characterization" and the "immediate income characterization." Under the self-created property characterization, rewards tokens are viewed as new property created by the staker and are not subject to taxation until later sold. Under the immediate income characterization, the value of the rewards tokens must be included in taxable income when the rewards tokens are received. The self-created property characterization is generally thought to be more advantageous because it defers the recognition of income, although the position that is most advantageous depends on each taxpayer's individual situation.

1. Self-Created Property Characterization

Under the self-created property characterization, the staker is viewed as creating the rewards tokens.[26] Generally, the creation of property is not itself a taxable event. Rather, income from such self-created property is generally realized only when the property is later sold. For example, a farmer recognizes income when crops are sold, not when they are grown.[27] Similarly, an "actual" miner recognizes income when minerals are sold, not when they are mined or when they are discovered.[28] One can think of numerous situations in which the creation of property by a taxpayer is not subject to tax even though the taxpayer has experienced an accession to wealth as a result of having created the property. If this were not the case, taxpayers would have reportable taxable income whenever they created property for any purpose (even for personal use). Clearly, that is not the current state of the law.

The proponents of the self-created property characterization not only believe that staking rewards are analogous to these self-created scenarios under existing law, but also note that the fair market value of staking rewards, at the time of receipt, may not accurately represent a taxpayer's true accession to wealth from the staking activity.[29] In many cases, the staking rewards are inflationary; that is, the staking rewards, on account of the creation of new units on the blockchain, reduces the value of the units already in existence. For this reason, proponents of this view argue that imposing taxation on the value of the staking rewards without accounting for the reduced value of the taxpayer's existing cryptocurrency results in systematic over-taxation when compared to the taxpayer's true economic gain. From a pure policy standpoint, there is certainly some merit to the argument that taxpayers should not be subject to taxation on more than their economic gain. However, the U.S. tax system rarely takes inflationary concerns into account when determining a taxpayer's gross income, and it is not clear that staking rewards should be an exception to this general state of affairs.[30] Note also that this can cut both ways. As described above, there are some blockchains where the rewards systems are (or may be) deflationary after considering transaction fee burns. In the same way that an inflationary blockchain could result in systemic over-taxation, a deflationary blockchain arguably results in systemic under-taxation because the appreciation in the value of existing cryptocurrency holdings (as a result of deflationary burns) is not accounted for when determining the taxable income from the staking activity until those tokens are sold.

The self-created property characterization has received a fair degree of press. In 2020, several members of Congress wrote a letter to the IRS expressing support for this characterization.[31] More recently, the headlines have focused on *Jarrett v. United States*, a case being litigated in District Court (in Nashville).[32] In the case, the taxpayers, Joshua and Jessica Jarrett, sought a refund of tax paid on staking rewards involving Tezos. The Jarretts asserted the self-created property characterization as part of their claim, and the IRS recently offered to grant them the refund. However, in doing so the IRS did not provide any rationale, analysis, or admission of the Jarretts' technical position. The Jarretts rejected the IRS's refund offer and have sought a court ruling that would create precedent and prevent the IRS from challenging their position in the future. The government has filed a motion to dismiss the case.[33]

Some have construed the grant of the refund to the Jarretts as a concession by the IRS on the technical merits of the self-created property characterization, such that perhaps staking rewards are now not taxable until later sold.[34] However, the government can settle litigation for a variety of reasons and these reasons may have nothing to do with the government's perception of the strength of its arguments in a case relative to those of the taxpayer. In this case in particular, the dollar amount at issue (less than $4,000) and the jurisdiction (District Court rather than Tax Court) could have played a role in the decision.[35] For its part, the government has described the inferences drawn from its refund decision as "little more than speculation."[36] Accordingly, taxpayers would be well advised not to construe the issuance of a refund here as an indication of the IRS's position on the proper treatment of staking rewards or as binding precedent.

2. Immediate Income Characterization

There are several distinct arguments that can be made in favor of the immediate income characterization.

Perhaps the primary argument is that staking rewards simply constitute an immediate accession to wealth and therefore constitute gross income. In this regard, Code Sec. 61(a) provides that "gross income" means all income from whatever source derived. Code Secs. 61(a)(1)-(14) provide specific examples of gross income, but these examples are not all encompassing.[37] Therefore, an argument in favor of the immediate income characterization is that although staking rewards are not easily analogized to existing categories of income, they nevertheless represent an accession to wealth that is taxable as gross income under Code Sec. 61(a).

As noted above and as is set forth in Notice 2014-21, the IRS is of the view that a PoW mining reward is taxable as gross income upon receipt and given the challenge in *Jarrett*, it is presumably of a similar view regarding PoS rewards, generally.[38] The IRS did not state in Notice 2014-21 that there is a "service" component to PoW mining, but arguably mining and staking rewards could be viewed as compensation for services rendered (*i.e.*, maintaining the blockchain) and therefore includable in gross income under Code Sec. 61(a)(1). The strength of this position may depend to some extent on the characteristics of the blockchain in question. For example, on certain blockchains, a portion of the reward tokens paid to a validator are specifically denoted as "transaction fees" paid by parties executing smart contracts. In those cases, it may be difficult to argue that this portion of the reward tokens is not paid as compensation for services.[39] However, on other blockchains, transaction fees are "burned," and the rewards tokens received by validators are always newly created tokens. In these situations, no portion of the staking reward is a transaction fee from a user and the argument for treating rewards tokens as in-kind payments for services rendered becomes more difficult. Nevertheless, some commentators argue that newly created staking rewards are compensation to the staker. This conclusion is premised on the "blockchain," rather than the staker, creating the tokens and then transferring them to the staker as compensation for maintaining the integrity of the blockchain.[40] Unlike traditional scenarios with newly created property (*e.g.*, a farmer and his or her crop), the task here is not to create the reward but rather to validate a given transaction. Put another way, and continuing with the farmer and crop analogy, it is perhaps as if the staker or validator is the farm *worker* (and not farm owner) who is compensated or paid in crop (instead of cash).[41]

However, one question here is whether it is even possible to perform a service for a non-person or non-entity, such as a decentralized public blockchain.[42] Clearly, services can be performed for individuals and entities such as corporations and partnerships, *i.e.*, "persons" as defined under Code Sec. 7701(a)(1). But, what about in other scenarios, such as with a blockchain, where there is no owner or "person" involved? Put another way, perhaps compensation for services can truly arise only in scenarios where an amount (whether paid in kind or cash) comes from a person; in other instances, it perhaps is newly created property, and not subject to immediate taxation.[43] This would, in effect, create a distinction between the rewards tokens that comprise transaction fees and the rewards tokens that are newly issued. The former would be compensation and the latter would be self-created property. However, and given that the blockchain is a man-made system, with a carefully designed rewards program, perhaps this is simply taking things too far.

There is also an argument that the staking rewards are akin to rent or royalty payments. In general, a royalty is a payment for the use of a right and rent is a payment for the use of property. Either characterization could arguably describe a staking arrangement. That is, the staker allows another party to use the staked cryptocurrency in exchange for a stream of payments that are paid in kind. Rent and royalty income is generally includable in income when paid or accrued, depending on the taxpayer's method of accounting. Thus, this characterization would also give rise to taxable income when staking rewards are paid to the staker.

Yet another potential argument for upfront taxation is that staking rewards represent a windfall gain that constitutes gross income.[44] This position would essentially analogize the act of staking to entering into a lottery and the staking rewards to lottery winnings. Although there are some superficial similarities (*e.g.*, the block producer is generally randomly selected in by an algorithm that operates similar to a weighted lottery), this analogy ignores the significant investment of resources involved and the underlying purpose of the staking activity. Consider, for example, the distinction made between a prospector who through his or her efforts finds gold deposits on his or her land and a person who simply finds buried treasure trove in his or her backyard. Only in the case of the backyard treasure trove is the value of the property immediately taxable.[45] The distinction between these two situations is presumably the effort put forth by the taxpayer. Unlike the winner of a lottery or the finder of treasure, a staker obtains staking rewards as the consequence of deliberate and sustained action and a significant investment of capital. For this reason, the windfall gain theory for upfront taxation may not be strong.

Note, however, that the staking rewards likely are not treated as interest, given that the staking arrangement should not be characterized as a loan or creating indebtedness for U.S. federal income tax purposes.[46]

3. Summary—Timing

In the absence of further and definitive guidance from the IRS, taxpayers and their tax advisors will need to form their own conclusion as to whether the self-created property characterization or the immediate income characterization is correct. It is not entirely clear that staking rewards fit neatly into the existing confines of self-created property characterization—blockchain technology is new, novel, and not easily analogized. As such, it is certainly possible that a court would adopt the immediate income characterization on the basis that staking rewards represent a form of service income or an item of new, previously unclassified, gross income.

B. Character

The character of an item of income, gain, deduction, or loss as capital or ordinary is important for a number of reasons. Capital gains may be subject to preferential tax rates,[47] capital losses are subject to special limitations that do not apply to ordinary losses,[48] and there are other distinctions drawn between the different classes of income that can affect a taxpayer's overall tax position.[49]

Generally, capital gain or loss is only possible if there has been a sale or exchange of a capital asset.[50] If there has not been a sale or exchange (or a deemed sale or exchange), any income or loss resulting from the transaction is ordinary. If an asset other than a capital asset is sold or exchanged, the gain or loss on the sale or exchange is likewise ordinary.[51]

The characterization of staking income as ordinary income or capital gain may depend to a significant degree on the way in which the overall transaction is viewed.

Under the immediate income characterization, the receipt of staking rewards gives rise to taxable income. The receipt of staking rewards is not part of a sale or exchange, such that the income is necessarily ordinary in character.[52] The staker then takes basis in the cryptocurrency received equal to its fair market value, which is also equal to the amount of income recognized. When the cryptocurrency received as a staking reward is later sold or exchanged, any gain or loss would be capital if the cryptocurrency is a capital asset in the hands of the taxpayer and ordinary if it is not. In many instances, the statutory framework set forth in Code Sec. 1221 (discussed further below) suggests that the staking reward, following receipt, can be a capital asset.[53] Thus, under the immediate income characterization, a portion of the economic return from the staking activity would be ordinary income (*i.e.*, the initial value of the rewards tokens), and a later portion could be characterized as capital gain or loss (*i.e.*, any increase or decrease in value from the date of receipt).

If the immediate income approach is applied and the price of the cryptocurrency declines from the date on which the staking rewards are received to the date on which the staking rewards are sold, the taxpayer would recognize ordinary income and a partially offsetting capital loss. If the capital loss were limited, this could result in significantly more income being subject to taxation than the total income realized (which is already arguably more than the taxpayer's real increase in wealth for inflationary blockchains).[54]

Example #1

Connor receives 100 XTZ as a staking reward on October 3, 2021 when the price of XTZ is $9.14. On February 24, 2022, Connor sells the XTZ received as a staking reward for $265.

For purposes of this example, assume that Connor: (i) is subject to a 37 percent marginal ordinary income tax rate, (ii) is subject to a 20 percent capital gains tax rate, (iii) holds XTZ as a capital asset, and (iv) has no capital gains, other sources or capital losses, and would not benefit from capital loss carrybacks or carryovers.

Under the immediate income characterization, Connor recognizes $914 of ordinary income in 2021 (100 XTZ × $9.14/XTZ) and pays $338 of tax. In 2022, Connor recognizes a $649 capital loss for the difference between the amount realized on the sale ($265) and his basis in the XTZ that were sold ($914). As a result of this staking activity, Connor has cumulative pre-tax income of $265 and an after-tax loss of $73 ($265 received on sale, minus $338 of taxes paid).

Under the self-created property characterization, income or loss is not recognized until the cryptocurrency received as a staking reward is sold, exchanged or otherwise disposed of in a taxable transaction. If the recognition of income is tied to a sale or exchange event, does this mean that the entire amount of economic income or profit from the staking activity could be treated as capital gain? Some commentators have indicated that the answer to this question is "no."[55] However, and as is further discussed below, the relevant statutory framework as set forth in Code Sec. 1221 suggests that a staking reward could be considered a capital asset that produces capital gain when sold, at least in certain circumstances. This approach would always result in a gain equal to the gain realized from the staking transaction and avoids the issue of character mismatches. Further, if the cryptocurrency being sold is a capital asset in the hands of the taxpayer, the income from the transaction might be subject to a lower rate of taxation.

Example #2

Assume the same facts as in Example #1. Under the self-created property characterization, Connor recognizes no income and pays no tax in 2021. When the XTZ is sold in 2022, Connor recognizes a $265 capital gain and pay $53 of tax. Connor has cumulative pre-tax income of $265 and cumulative after-tax income of $212 ($265 received on sale, minus $53 of taxes paid).

1. Capital Asset Defined

In either the immediate income characterization or the self-created property characterization scenarios, the outcome is dependent on whether the staking reward is a capital asset when later disposed of (assuming such disposition constitutes a "sale or exchange"). Whether an asset is a "capital asset" is governed by Code Sec. 1221, which defines a "capital asset" by exclusion as all property held by a taxpayer (whether or not connected with a trade or business) *other than* property described in Code Secs. 1221(a)(1)–(8). Whether cryptocurrency could be considered a capital asset under these rules is considered below.

2. Code Sec. 1221(a)(1)—Inventory and Dealer Property

Code Sec. 1221(a)(1) excludes from the definition of a capital asset stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year ("inventory property"), or property held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business ("dealer property"). For most stakers, cryptocurrency is not inventory property, but in certain cases could be dealer property.[56] Generally, there are four requirements for dealer property: (i) the property must be held primarily for sale (the "primarily for sale requirement"), (ii) the property must be held for sale to customers (the "customer requirement"), (iii) the taxpayer must be engaged in a trade or business (the "trade or business requirement"), and (iv) the property must be for sale in the ordinary course of the taxpayer's trade or business (the "ordinary course requirement").[57] The question of whether these requirements are met is inherently factual.[58]

a. Primarily for Sale Requirement. Although property may be used for more than one purpose, only property held "primarily" for sale to customers may be excluded as a capital asset under Code Sec. 1221(a)(1). The Supreme Court has stated that the word "primarily" means "of first importance" or "principally" in the context of Code Sec. 1221(a)(1).[59]

The manner in which a taxpayer generates profits may demonstrate whether an asset is held primarily for sale or for some other purpose. If the primary driver of business profits is the sale of property, the property is generally viewed as held primarily for sale even if it serves significant secondary purposes.[60] In contrast, where a taxpayer holds a property for its income yield, the property is generally not considered to be held primarily for sale.[61]

If a taxpayer's rewards tokens are staked to generate additional staking returns, it would likely fail the primarily for sale requirement. However, if a taxpayer frequently sells staking rewards shortly after acquisition, the primarily for sale requirement may be met.

b. Customer Requirement. The words "to customers" were added to Code Sec. 1221(a)(1) to clarify that gains and losses of traders (and investors) in property such as stock or securities are capital gains and losses.[62] As a result of its relatively tailored purpose, this factor is given significantly less weight outside of the context of securities transactions but has been continuously reinforced by the courts and the IRS in the context of securities transactions.[63] Cryptocurrencies are not traditional securities. However, cryptocurrency market participants are, in many respects, similar to those participating in the stock and securities markets and they often consider themselves traders, investors, or dealers in cryptocurrency.[64] For this reason, it would seem appropriate to consider the customer requirement in the cryptocurrency context.[65]

Authorities considering the distinction between a dealer and a trader emphasize the manner in which a taxpayer is compensated in determining whether a dealer–customer relationship exists. In *Kemon v. Commissioner*,[66] an oft-cited case discussing this concept of "held primarily for sale to customers" for purposes of Code Sec. 1221, the Tax Court stated that:

> Those who sell "to customers" are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middle man bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods …. Such sellers are known as "dealers."[67]

As this passage indicates, a dealer generally does not earn income from increases in the value of securities owned or advantageous purchases and sales of securities.[68] Rather, a dealer profits through market-making activities and acquires securities for the purpose of meeting customer demands.[69] To this end, courts have often used a merchant analogy to differentiate a dealer from a mere trader or investor. Dealers, like merchants, purchase securities with the expectation of selling them to customers at a profit.[70] This profit is not due to a rise in value of the securities during the time the securities were held by the dealer; rather, it is due to a mark-up for bringing together a buyer and seller.[71] Thus, when assessing whether a taxpayer is transacting with a "customer," the courts and the IRS generally look to the manner in which the taxpayer is compensated. Dealers perform a service and are compensated for that service, whereas customers are the party for which a service is performed.[72]

While not determinative, the courts have also looked to the extent and degree of solicitation[73] or marketing activities[74] to help determine whether a dealer–customer relationship is present. To the extent a taxpayer engages in promotional activity to drive sales (or purchases), it is more likely that a dealer–customer relationship is present.

When considering the customer requirement, in CCA 200817035 the IRS concluded that the taxpayer did not sell securities to customers and cited the following factors as indicators that a dealer–customer relationship was not present: (i) the taxpayer did not earn a dealer commission or spread on the sale of the securities, (ii) the taxpayer appeared to be the customer of the parties to which it sold securities (thereby implying that the purchasers were not customers of the taxpayer), (iii) the taxpayer did not acquire securities for the purpose of fulfilling customer purchase orders, (iv) the taxpayer did not immediately sell the securities it purchased, (v) the taxpayer's sales were motivated by capital requirements, and (vi) the taxpayer did not hold itself out to the market as a dealer.

To the extent the customer requirement is relevant in the context of cryptocurrencies, it should not be met unless the seller is performing a service for the buyer (*i.e.*, providing a ready supply of cryptocurrency to satisfy the buyer's demands). The factors described in CCA 200817035 also provide useful guideposts. It seems unlikely that most stakers would satisfy this standard, especially if they hold cryptocurrency for a significant period of time and with a view towards long-term price appreciation.

c. Trade or Business Requirement. To be a dealer, the taxpayer must be engaged in a trade or business. Whether a trade or business exists is a fact-intensive inquiry. Several considerations for stakers are discussed later in this article, and it is conceivable that some stakers (especially those that self-stake extensively) could be engaged in a trade or business.

d. Ordinary Course Requirement. Whether property is held for sale in the ordinary course of a trade or business is a facts-and-circumstances test.[75] In cases where the purpose for entering into a transaction is "entirely divorced" from its trade or business,[76] or which suggests an intent to depart from a taxpayer's regular business practices,[77] courts will generally refuse to consider the transaction in the ordinary course of a taxpayer's trade or business.

e. Conclusion. Although there will certainly be exceptions, in many cases stakers will not satisfy all of the requirements for dealer property. If any one of the requirements is not satisfied, the staking rewards should not be classified as ordinary assets under Code. Sec. 1221(a)(1).

3. Code Sec. 1221(a)(2)—Depreciable Property

Code Sec. 1221(a)(2) excludes from the definition of a capital asset property, used in a trade or business, of a character that is subject to the allowance for depreciation provided in Code Sec. 167, or real property used in a trade or business. If a taxpayer plans to stake the cryptocurrency received as a staking reward, the cryptocurrency may be considered property used in a trade or business (*see* discussion below). However, an intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation.[78] Most cryptocurrency assets do not have a limited useful life and would therefore be ineligible for depreciation and, as a result, would not be ordinary property by reason of Code Sec. 1221(a)(2).

4. Code Sec. 1221(a)(3)—Self-Created Art and Intellectual Property

Code Sec. 1221(a)(3) excludes from the definition of a capital asset a patent, invention, model, or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, if the taxpayer's personal efforts created the property.[79] It seems reasonably clear that staked cryptocurrencies do not fall within this category of ordinary assets.[80] Even though this category of ordinary assets is not directly relevant, Code Sec. 1221(a)(3) is worth examining, especially in the context of the self-created property characterization given that the theory behind it involves newly created property. The predecessor of Code Sec. 1221(a)(3) was enacted in 1950 to provide that self-created inventions, copyrights, and artistic works are not considered a capital asset.[81] This change was made in response reports that General Dwight D. Eisenhower had treated the sale of the rights to his book, *Crusade in Europe,* as capital gain income subject to a 25 percent rather than ordinary income subject to a 77 percent rate.[82] The basis for Eisenhower's position was that he was an amateur writer entitled to capital gains treatment under previous judicial decisions that had treated property created by an amateur as a capital asset and property created by a professional as ordinary property under the predecessor to Code Sec. 1221(a)(1).[83] The predecessor to Code Sec. 1221(a)(3) was enacted to ensure that professionals and amateurs were on a level playing field and subject to ordinary income rates on the product of their labor. After its initial enactment, Code Sec. 1221(a)(3) was subsequently expanded several more times to address other categories of property Congress felt should be subjected to ordinary income rates.[84]

As previously noted, some tax practitioners have jumped from the conclusion that staking rewards are self-created property to the conclusion that the income from the sale of these assets is ordinary. However, the fact that a farmer derives ordinary income from the sale of crops does not mean that the sale of all self-created property is ordinary. The crops produce ordinary income because they are Code Sec. 1221(a)(1) assets in the hands of the farmer, not because there is a general rule requiring that all income from the sale of self-created assets is treated as ordinary income. The enactment of Code Sec. 1221(a)(3) and its repeated expansion demonstrates that, absent inclusion in a category of ordinary assets under Code Sec. 1221, self-created property is a capital asset. If that were not the case, there would be no reason for Code Sec. 1221(a)(3) to exist. The case law predating Code Sec. 1221(a)(3) is also informative in that it shows that courts and IRS would likely evaluate whether self-created property is an ordinary or capital asset through the statutory framework of Code Sec. 1221 (and in particular Code Sec. 1221(a)(1)). Thus, if a taxpayer adopts the self-created property characterization and is confident that their cryptocurrency rewards are not a category of ordinary property under Code Sec. 1221, the taxpayer should be able to achieve capital gains treatment on the sale of the rewards tokens.

5. Code Secs. 1221(a)(4)–(7)—Accounts Receivable, Government Publications, Commodities Derivatives, and Hedging Transactions

It seems reasonably clear that cryptocurrencies received as staking rewards are not accounts receivable, government publications, commodities derivatives, or hedging instruments as described under Code Secs. 1221(a)(4)–(7).

6. Code Sec. 1221(a)(8)—Supplies

Code Sec. 1221(a)(8) excludes from the definition of a capital asset supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer. Therefore, for property to be a supply, the taxpayer must be engaged in a trade or business, which is discussed below. A more fundamental question is whether cryptocurrency might be considered "used or consumed" by a staker. In a PoS blockchain, parties transacting on the blockchain must pay a "gas" fee in connection with each transaction. The gas fee is typically paid in the blockchain's native cryptocurrency (*i.e.*, the same cryptocurrency that staking rewards are paid in) and, in certain blockchains, some or all of this gas fee is permanently destroyed. In a sense, the taxpayer is consuming the native cryptocurrency every time a transaction is undertaken. If a taxpayer regularly uses smart contract capabilities in the ordinary course of a trade or business, does this mean the native cryptocurrency is an ordinary asset for that taxpayer?

At the outset, it is worth noting that the legislative history of Code Sec. 1221(a)(8) focuses on tangible assets and the IRS has previously ruled that intangible assets are not supplies, which creates some uncertainty as to whether cryptocurrency assets (as intangibles) could ever constitute supplies.[85] It is also important to consider the underlying purpose of Code Sec. 1221(a)(8), which was enacted so that supplies closely related to the taxpayer's trade or business would not create capital gain or loss if sold, rather than consumed.[86] This also had the effect of coordinating the general character rules with then applicable character rules for hedges of supplies.[87] This underlying purpose implies that whether property is classified as supply should depend on the primary purpose for the acquisition of the property—that is, property must be acquired primarily for consumption to constitute a supply. The limited case law considering the extent of Code Sec. 1221(a)(8) accords with this conclusion.[88]

The importance of the purpose the asset is held can be illustrated by the following examples.

Example—Cryptocurrency Trader

A cryptocurrency trader effectuates trades primarily through decentralized exchanges and pays a gas fee in connection with each trade. The trader trades primarily in the blockchain's native currency, which is also the currency used to pay gas fees. The trader arguably "uses or consumes" cryptocurrency to pay gas fees, but the primary use of that cryptocurrency is as a trading asset. For this reason, it would appear that the cryptocurrency would likely not constitute a supply in the hands of the trader.

Example—Retail Business User

A retail business accepts payments in U.S. dollar stablecoins and incurs gas fees (denominated in the blockchain's native cryptocurrency) in connection with receiving these payments and converting them into actual U.S. dollars. The retailer does not otherwise transact on the blockchain. In this case, the use of the native cryptocurrency to pay gas fees is incidental to the company's primary business activities, not the focus of those activities. It therefore seems that the arguments for treating the native cryptocurrency as a supply would be significantly stronger in this context.

For stakers, the use of cryptocurrency to pay gas fees is generally subordinate to the primary use of the cryptocurrency as an investment asset. For this reason, it would appear that cryptocurrency is generally not a supply in the hands of a staker. Further support for the position that cryptocurrencies are not supplies can be found in previous IRS guidance, which held that intangible assets are not supplies.[89] There is also the possibility that some stakers are not engaged in a trade or business and in those cases staking rewards could not be considered ordinary assets under Code Sec. 1221(a)(8).

7. Summary—Character

The question of whether cryptocurrency received as staking rewards is an ordinary or capital asset in the hands of the taxpayer is an important question under either the immediate income characterization or the self-created property characterization. In either case, the character of the gain or loss realized when the staking rewards are sold will be ordinary or capital depending on whether the rewards tokens are a capital asset in the hands of the taxpayer. While there will certainly be exceptions to the general rule, it appears that staking rewards constitute capital assets in the hands of most stakers and will therefore produce capital gain or loss when sold.

C. Trade or Business

As demonstrated above, whether a taxpayer is engaged in a trade or business can affect the character of staking rewards tokens as capital or ordinary assets. However, the concept of a "trade or business" is important for a variety of reasons—not just character. Deductions incurred in connection with a trade or business are classified as Code Sec. 162 deductions and are generally not subject to limitation. In contrast, expenses that are not incurred for the production of income, but not in connection with a trade or business, are generally classified as Code Sec. 212 expenses that are not currently deductible by individuals.[90] For this reason (and several others), U.S. taxable investors will generally prefer that their cryptocurrency activities be characterized as a trade or business.

The concept of a "trade or business" is one that is alluded to in numerous subsections of the Code and regulations, but is not defined therein. The courts, led by the Supreme Court in its 1941 decision in *Higgins v. Commissioner*,[91] have stressed that whether the activities of the taxpayer constitute a trade or business requires an examination of the facts and circumstances in each case.[92] In attempting to define what a trade or business means, one court has stated:

> The phrase "trade or business" connotes something more than an act or course of activity engaged in for profit. The phrase must refer not merely to acts engaged in for profit, but to extensive activity over a substantial period of time during which the Taxpayer holds himself out as selling goods or services. A taxpayer can show that his activities are a "business" by demonstrating that he devotes a substantial portion of his time to the activities or that there has been extensive or repeated activity over a substantial period of time.[93]

The courts have repeatedly focused on the two elements described in this passage when examining a taxpayer's activities, namely: (i) the intention to make a profit or produce income (the "profit motive test"), and (ii) whether there is extensive activity over a substantial period of time (the "continuous and regular test").

The meaning of the term "trade or business" has been considered at length by other authors.[94] Therefore, no attempt is made here to provide an exhaustive analysis of the factors considered by the courts. However, some context regarding the profit motive test and several analogies and points of reference in the context of the continuous and regular test are set forth below, which may prove useful when evaluating whether a trade or business is present.

1. Profit Motive Test

An activity is only carried out "for profit" if the taxpayer had a good faith intention to make a profit when entering into it.[95] While a belief that the activity will generate a profit is sufficient,[96] the mere hope absent any specific plan has been held to be in bad faith, and therefore insufficient to establish profit motive.[97] Activities entered into for the purpose of generating tax shelters or other tax benefits were held to lack profit motive.[98] Actual profit is not required to establish profit motive, a taxpayer only has to show that there is a potential for profit.[99]

Certain factors have been identified by the courts as indicators of a profit motive; these factors are summarized in the regulations under Code Sec. 183, which govern whether an activity undertaken by an individual or an S corporation has a sufficient profit motive.[100] The factors are: (i) manner in which the taxpayer carries on the activity; (ii) expertise of the taxpayer or his advisors; (iii) time and effort expended by the taxpayer; (iv) expectation that assets used in activity may appreciate in value; (v) success of the taxpayer in carrying on other similar or dissimilar activities; (vi) the taxpayer's history of income or losses with respect to the activity; (vii) the amount of occasional profits, if any, that are earned; (viii) the financial status of the taxpayer; and (ix) elements of personal pleasure or recreation. The above list is nonexclusive, and the presence or absence of one or more factors does not establish or negate profit motive; ultimately the determination is made based on a totality of the facts and circumstances.

It appears that the profit motive test will generally be met by stakers. Staking is a low-risk venture and the profits derived therefrom are relatively predictable. Therefore, it would stand to reason that stakers reasonably expect to derive a profit from the activity. In addition, there is generally not a personal or recreational motivation for staking—*i.e.*, stakers generally undertake the activity for its profit-making potential.

2. The Continuous and Regular Test

When considering the continuous and regular test, a useful point of reference is the IRS's stance on mining activities. The government clearly believes that mining activities can, at least in certain circumstances, constitute a trade or business.[101] It would therefore stand to reason that staking activities could also rise to the level of a trade or business if carried out actively and at scale. For example, a large firm that acts as a validator, accepts stakes from delegators, actively solicits customers, regularly sells staking rewards, and maintains and office and employees would clearly be engaged in a trade or business.

On the other end of the spectrum are parties using delegated staking to increase the amount of cryptocurrency they hold for their long-term appreciation potential. It is not clear that these passive investors could satisfy the continuous and regular test so as to be engaged in a trade or business.

In this context of investment activities, particular attention should be paid to *Higgins v. Commissioner*, which dealt with stock and bond investments.[102] In that case, the Supreme Court concluded that a taxpayer who merely kept records and collected interest and dividends from his securities was not engaged in a trade or business even though he devoted a considerable portion of his time to the oversight of his large portfolio of securities and hired others to assist him in offices rented for that purpose. According to the Court, managerial attention to one's investments does not constitute a trade or business "[n]o matter how large the estate or how continuous or extended the work required may be."[103] It is quite possible that cryptocurrency staking (especially delegated staking) would be viewed as an investment activity, and therefore not a trade or business under the *Higgins* decision. But even though cryptocurrency staking rewards are similar in some respects to stock dividends and bond interest, cryptocurrency is a fundamentally different asset class than stocks and bonds and there are important differences between the income streams. For example, some modicum of activity is required, such that staking is not exactly comparable to the simple passive collection of interest or dividends. Accordingly, the application (or non-application) of *Higgins* is not clear.

Apart from stocks and bonds, the nearest guidepost is likely the authorities considering whether rental real estate activities constitute a trade or business. Like staking, rental real estate activities can be relatively small scale and generate passive returns or can be quite substantial and active. Thus, it provides a useful barometer as to where a court would draw the line between business activity and nonbusiness activities.

If rental real estate is managed by the taxpayer, it appears that the threshold for a trade or business is relatively low—even renting a single property for a three-year period has been held to constitute a trade or business.[104] However, in cases where the taxpayer and his or her agents have very little active role with respect to the property—*e.g.*, where a single property was rented out on a "net" basis to a single tenant—the courts have concluded that no trade or business was present.[105]

It is tempting to compare the cases involving actively managed rental real estate (a trade or business) to self-staking and the cases involving rental real estate passively managed on a "net" basis (not a trade or business) to delegated staking. The self-staker has an active role in the generation of staking rewards and the protection of capital because the self-staker must actively run a node on a continuous basis to avoid slashing. The active owner/landlord is also involved with the rental property and must collect rent, negotiate a lease, and maintain the property. In both cases, the time investment may not be substantial, but there are at least some tasks undertaken directly by the taxpayer. In contrast, the delegated staker has virtually no role in the generation of staking rewards similar to the owner/landlord renting property on a net basis. In the case of passive real estate investing, the tenant has essentially been "hired" to maintain the property and perform other services in exchange for a reduction in rents. This is similar to a staker that delegates, who accepts a lower staking reward in exchange for the validator performing the validation activities on their behalf. In the delegated staking context, whether the validator is viewed as the agent of the delegated staker may be particularly important.[106]

As with many scenarios in the cryptocurrency space, it is difficult to know when analogies to existing tax law are not to be relied upon. Activities undertaken on a blockchain are simply fundamentally different from those in the tangible world that the courts have considered in the past, and staking activities defy ready analogy. Unfortunately, this means that it will be difficult for many taxpayers to achieve a high degree of comfort on their trade or business position in the absence of further guidance.

D. Delegated Staking—Tax Partnership?

With PoW mining, it is not uncommon for participants to combine efforts in a "pool" and share any resulting mining rewards in some manner. For example, a participant in such a pool may contribute computer power to those that actually engaged in the PoW mining activity in exchange for a share of the mining reward. One issue that arises with such "pools" is whether the arrangement constitutes a partnership for U.S. federal income tax purposes. A similar issue may arise in the delegated staking context—that is, perhaps participants that allow their cryptocurrency to be staked with an active validator could be treated as being in an arrangement or joint venture with the validator that is classified as a partnership for U.S. federal income tax purposes.

The Code defines a "partnership" very broadly so as to include a "syndicate, group, pool, joint venture, or other unincorporated organization through or by the means of which any business, financial operation, or venture is carried on, and which is not … a corporation or a trust or estate …."[107] Certain contractual arrangements can result in a "deemed" tax partnership; that is, it is not necessary to have a legal entity under local law in order for there to be a partnership for U.S. federal income tax purposes.[108] A simple joint venture or other contractual arrangement may create a separate entity (*i.e.*, a partnership) for U.S. federal income tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.[109] However, a mere expense-sharing arrangement or mere co-ownership of property that is leased or rented does not necessarily create a partnership.[110]

Case law further indicates that whether a partnership exists depends on the facts and circumstances of the arrangement, and the Supreme Court in *Commissioner v. Culberston* stated that a partnership exists for U.S. federal income tax purposes when:

> "[C]onsidering all the facts—the agreement, the conduct of the parties in execution of its provisions,

> their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intend to join together in the present conduct of an enterprise."[111]

Subsequently, the Tax Court in *Luna v. Commissioner* provided a list of factors, none of which is conclusive, to be used in determining whether a joint venture could result in a tax partnership:

> "The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to the [IRS] or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise."[112]

The simple sharing of gross proceeds or gross receipts, as opposed to the sharing of net profits, appears to indicate that an arrangement is not properly classified as a partnership for U.S. federal income tax purposes.[113]

Finally, the so-called "Check-the-Box" regulations require that for a joint venture to be classified as a partnership, it must not be a corporation, it must have at least two members, and it cannot be a joint undertaking merely to share expenses.[114]

It may not be entirely clear whether delegated staking arrangements could result in a deemed partnership for U.S. federal income tax purposes. On the one hand, it would not appear that the parties intend to join together in the conduct of an enterprise, the business is likely not conducted in the joint names of the parties, and there likely is not joint control over the arrangement. In addition, in many instances it could well be that the parties are sharing *gross* proceeds or *gross* receipts with respect to the staking rewards (as opposed to "net" profits), which would further suggest that partnership status is not warranted. On the other hand, it does appear that it is a contribution of capital and services, and in some situations there could be sharing of net profits (and losses). Of course, treating these arrangements as partnerships for tax purposes is wholly inconsistent with the nature of blockchains, where anonymity is often preferred.[115]

If such arrangement is properly classified as a tax partnership, presumably such partnership now holds the underlying cryptocurrency being staked, and the deemed partnership, itself, is engaged in the staking activity. In particular, those staking are likely treated as contributing their cryptocurrency to the partnership,[116] with the third party conducting the validation activity likely holding a profits interest therein. If the partnership is engaged in a trade or business (on account of the validator's activities), then presumably each partner is likewise treated as so engaged.[117] As to staking rewards earned by the partnership, taxation to the partners will depend on whether the immediate income characterization or the self-created property characterization applies.

If there is a deemed tax partnership, consideration should be given to: timing and reporting issues, such as the requirement to file tax returns and provide Form K-1s to the partners, the tax year of the partnership (calendar or fiscal), its method of accounting (cash or accrual), as well as available tax elections, tax-withholding obligations, application of the partnership audit rules, and more.

IV. Part Three: U.S. Federal Income Tax Consequences—Non-U.S. Persons

A. Overview

Very generally, non-U.S. persons as defined in the Code[118] ("foreign persons") are subject to U.S. tax under one of two regimes depending on the level and nature of their activities in the United States.[119]

If a foreign person is considered to be engaged in a U.S. trade or business ("USTB"), then the foreign person generally will be subject to U.S. federal net income tax on income and gains that are effectively connected (or deemed effectively connected) with the conduct of that USTB ("ECI").[120] In addition to being subject to tax at graduated tax rates on such income and gains, the foreign person also will be required to file U.S. federal income tax returns in such case.[121] Furthermore, a foreign person classified as a corporation may also be subject to an additional branch profits tax in the amount of 30 percent of its after-tax ECI, unless reduced under an applicable income tax treaty.[122]

Many foreign persons, however, structure their activities (including especially investment activities) such that they are not considered to be engaged in a USTB. If not so engaged,[123] then a foreign person nonetheless can be subject to U.S. withholding taxes on certain U.S.-sourced income, which is often referred to as fixed, determinable, annual, or periodic ("FDAP") income.[124] Common examples include dividends and in some cases interest income. The gross amount of such FDAP income is generally subject to U.S. federal income tax at a rate of 30 percent, collected at source *via* withholding, unless such rate is reduced or eliminated under an applicable income tax treaty or unless a statutory exception under the Code applies.[125]

B. USTB and ECI

1. USTB, Defined

Except with respect to services and certain investment trading activities, neither the Code nor the regulations provide a comprehensive definition of what it means for a foreign person to be engaged in a USTB.[126] As is further explained below, the Code provides that the term USTB includes the performance of personal services within the United States at any time within the taxable year.[127] The Code also provides a safe harbor pursuant to which certain investment trading activities do not constitute a USTB.[128] For all other activities, however, one must generally look to case law for guidance. Notably, the standard for foreign persons to be considered to be engaged in a USTB may differ slightly from the more general rules described previously in this article.[129] However, in this context, the standards applied by the courts also have both a qualitative and quantitative component. For example, the Tax Court stated that a foreign person is generally treated as engaged in a USTB if its activity is "considerable, continuous, and regular."[130] Accordingly, whether a foreign person is engaged in a USTB is a facts-and-circumstances analysis.[131]

Special attribution rules can apply in this context. Therefore, a foreign person's activities may be passive, but the non-passive activities of others may cause it to be engaged in a USTB. For example, if a foreign person is a partner in a partnership that is engaged in a USTB, that foreign partner is also treated as engaged in a USTB.[132] That is, the USTB activities of the partnership are attributed to its partners. In addition, for purposes of this determination, the activities of all agents, whether dependent or independent, generally are attributed to the foreign person.[133] Therefore, a foreign investor may be treated as engaged in a USTB by reason of the activities of its agent. However, the boundaries as to what constitutes an "agency" relationship for this purpose may not always be clear, given that common law principles generally apply in this context. This is especially true in scenarios where the agent may not have authority to bind the principal or is not subject to a high degree of control by the principal.

However, case law provides that merely investing for one's own account (as opposed to more active trading activities) generally does not constitute a USTB, regardless of the level of activity involved. Therefore, a foreign person generally will not be considered to be engaged in a USTB if it is passively investing in the United States, such as by mere ownership of an investment asset or the simple management thereof, *e.g.*, the collection of rents, interest, and dividends.[134] This can be true even where some management is required with respect to the generated returns, if the foreign person does actively participate and its ownership stake is small.[135] However, determining where the "line" is between merely passively investing and engaging in a USTB (*e.g.*, on account of trading activities) is not always clear. For this reason, many foreign persons (including especially offshore hedge funds) rely on a safe harbor set forth in the Code, which generally provides that a foreign person will not be treated as engaged in a USTB if it limits its activities to trading in stocks, securities, or, in certain cases, commodities, for its own account, even if the foreign person effects its trading through a dependent agent in the United States.[136] This safe harbor, however, does not apply if the foreign person functions as a dealer.[137]

As mentioned above, performing services in the United States constitutes a USTB.[138] And, in one Tax Court case, it was held that a foreign person may be considered to perform services through the activities of an agent.[139] In addition, it appears that the threshold here is relatively low; that is, existing case law and guidance from the IRS seem to indicate that even minimal service activity performed in the United States can cause a foreign service provider to be treated as engaged in a USTB.[140]

Furthermore, to be engaged in a USTB the activities in question must generally occur within the United States. Put another way, in order for there to be a USTB, the taxpayer in question generally must carry on all substantive activities giving rise to such business within the United States, either directly or through its agents located in the United States. In this regard, services performed by individuals generally are sourced to the location where the services are performed, *i.e.*, U.S. sourced if performed in the United States,[141] and foreign sourced if performed outside the United States.[142] Where equipment or infrastructure is involved in the performance of a service, the location of the equipment appears to be relevant. For example, in one case a taxpayer was held not to be in a USTB by reason of operating a radio station in Mexico, even though listeners were located in the United States.[143] The Tax Court determined that the act of broadcasting (a service) occurred outside the United States, such that the income was not U.S. sourced. However, where an activity involves both infrastructure and human capital or labor, presumably the location of both must be taken into account. In this regard, whether services are considered to have been performed in the United States may not always be easy to determine, especially in the context of electronic transactions.[144] In addition, in certain cases it may not be entirely clear whether the activity involved is the performance of a service or perhaps something else.[145] Nevertheless, as a general rule, an enterprise is not considered to have performed services in the United States without *some* physical presence in the United States.[146] Therefore, one would think that if *all* operations are conducted outside of the United States, there can be no USTB.

2. Determining the Amount of ECI

If a foreign person is engaged in a USTB, then the foreign person is taxed on its income effectively connected with that USTB (*i.e.*, its ECI). Income from services giving rise to a USTB is generally treated as ECI.[147] Unfortunately, the applicable rules for determining and calculating ECI are not always entirely clear and therefore can be difficult to apply.

For example, the Code and the regulations provide detailed ECI rules for income that otherwise could be FDAP or capital gains (which gains generally are exempt from tax).[148] These amounts will be ECI only if an asset use test or a business-activities test is met, such that there is some connection to the foreign person's USTB.[149]

Under the asset use test, the inquiry is whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of the USTB. This test ordinarily applies where the trade or business activities as such do not give rise directly to the realization of the passive income, gain, or loss.[150]

Under the business-activities test, the inquiry is whether the activities of the USTB were a material factor in the realization of the income, gain, or loss. This test ordinarily applies where the income, gain, or loss which, even though generally of the passive type, arises directly from the active conduct of the taxpayer's trade or business in the United States.[151]

Different, and more detailed, rules apply to foreign persons that are in the active conduct of a banking, financing or similar business.[152]

3. Summary—USTB and ECI

Application of these principles to foreign persons engaged in staking activities appears to differ depending on *how* the staking is conducted, *i.e.*, whether the foreign person is engaged in self-staking or delegated staking, and *where* such activities occur.

Again, while there is no formal IRS guidance on the taxation of staking activities, many tax practitioners take the view that staking should be treated in a manner similar to mining, given that both activities involve a validation service of sorts. Therefore, where a foreign person, itself, engages in self-staking, or is a partner in a partnership that self-stakes, it appears that the staking activity, if conducted within the United States, can give rise to a USTB. In such a case, any staking rewards likely are ECI.[153]

As to where staking activities are deemed to occur, it would appear that if all activities, *i.e.*, infrastructure (node) and necessary personnel, are located and conducted outside of the United States, then by definition there should not be a USTB. However, in other instances, the answer may be less clear.

If the self-staking is *de minimis* or sporadic, and not "considerable, continuous, and regular," perhaps there is an argument that the activity is not sufficient to constitute a USTB. However, and as discussed above, it appears that the threshold here, especially with services, is extremely low.

As to delegated staking (where the foreign person delegates the validation activity to another), there may be a position that delegated staking may not constitute a USTB and therefore does not generate ECI. In particular, with certain arrangements an argument can be made that there perhaps is no "agency" relationship with the validator, such that its activities are not attributed to the foreign person who is simply locking its cryptocurrency and receiving a staking reward. In other scenarios, it may be possible to clearly identify a node operator who is not located in the United States, such that even if there is an agency relationship there simply is no USTB to be attributed. An argument also can be made that staking *via* delegation is a passive investment activity that does not give rise to a USTB. In particular, in certain cases it does appear that delegated staking simply involves the generation of passive returns on cryptocurrency already held as an investment, while at the same time protecting that investment against dilution (due to the inflationary effect on account of newly issued cryptocurrency) that otherwise would result if the foreign person did not stake. None of these positions, however, is without risk. Accordingly, some foreign persons may wish to take a more conservative approach, and simply "block" all staking activity *via* a U.S. "blocker" corporation (a strategy familiar to offshore hedge funds).

Finally, it is worth noting that there is some additional ECI risk here with respect to staking rewards when they are later sold, exchanged, or otherwise disposed of in a taxable transaction. As discussed above, there is a position under the Code Sec. 1221 statutory framework that staking rewards, when later sold or exchanged, can produce capital gain. Therefore, even where a foreign person reports staking rewards upfront as ECI, it appears that a later sale or exchange of that reward can produce gain that should be exempt from U.S. tax (assuming the foreign person is not otherwise engaged in a USTB). However, and on account of the asset use test in the regulations discussed above,[154] the fact that the staking rewards, when received, produce ECI could require that *later* gain on the ultimate sale or exchange of the cryptocurrency involved could likewise constitute ECI. More specifically, it appears that the gain on the subsequent sale or exchange is derived from assets used in, or held for use in, the conduct of the USTB (*i.e.*, the cryptocurrency that was staked) per the asset use test set forth in the regulations.[155] That is, the ECI "taint" could continue.

C. U.S.-Sourced FDAP

Even if the income in question is not ECI, a foreign person can nonetheless be subject to U.S. withholding tax on certain types of U.S.-sourced FDAP income.

1. FDAP, Defined

FDAP income is defined in the Code to specifically include certain specified items of gross income, such as interest,[156] dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments. It also includes "other fixed or determinable annual or periodical gains, profits, and income."[157] For example, the regulations promulgated under this Code provision provide that royalties, including royalties for the use of patents, copyrights, secret processes and formulas, and "other like property," are also FDAP income.[158] These regulations then refer to regulations promulgated under Code Sec. 1441 for further guidance,[159] which regulations provide that FDAP income generally includes "all other income included in gross income under Code Sec. 61."[160] Therefore, FDAP income is very broadly defined.[161] Prizes and awards could be considered FDAP under this broad definition.[162] However, gain from the sale of property generally is not FDAP.[163]

2. Sourcing

If the FDAP income in question is from foreign sources, however, foreign persons generally are not subject to withholding tax. Only U.S.-sourced FDAP is subject to withholding. The Code and the regulations provide detailed rules for purposes of sourcing income and gains.[164] For example, interest paid by the U.S. government, or the District of Columbia, as well as interest on bonds, notes, or other interest-bearing obligations of noncorporate residents or domestic corporations is treated as U.S. sourced,[165] as are dividends paid by a domestic corporation.[166] Likewise, compensation paid for labor or personal services performed in the United States is generally treated as U.S. sourced,[167] whereas an amount so paid for labor or services performed outside the United States is generally treated as foreign sourced.[168] Gains from the sale of personal property, however, are generally treated as sourced by reference to the country in which the seller is resident.[169]

For royalty income, the Code provides that sourcing is based on where the underlying property is located or used and not based on the location of the payor (licensee).[170] Therefore, royalties paid for the use of property in the United States is U.S. sourced, whereas royalties paid for the use property outside of the United States is foreign sourced. The Code provides that these rules apply to patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property. However, neither the Code nor the regulations provide a definition of "royalties" for this purpose. In certain cases, it may not be clear whether the amount paid is a royalty or instead a payment for services. In addition, in many cases it may not be entirely clear where the underlying property is used, making sourcing quite difficult.[171]

Interestingly, there is authority that suggests that prizes and awards, including for "puzzle-solving contest activities," should be sourced to the payor.[172]

When an item of income is not classified squarely within the rules set forth in the Code or the regulations, the courts have sourced the item by comparison with and analogy to classes of income specified within these rules, *i.e.*, by analogy to an item that most closely resembles the item in question.[173] However, and significantly, the regulations specifically provide a presumption that an amount shall be treated as being from sources within the United States if the source of the amount cannot be determined at the time of payment.[174]

3. Summary—FDAP

Again, there may be a position that delegated staking activities do not give rise to a USTB, such that the next inquiry is whether staking rewards in this context could be subject to FDAP. The distinction between the immediate income characterization and the self-created property characterization appears to be quite significant in this context.

If the immediate income characterization applies, a gating question is whether the staking income is U.S. sourced. Determining source seems to depend on the underlying theoretical basis one determines is applicable in concluding that the immediate income characterization is correct.

If staking, generally, is viewed as performing a (validation) service for the blockchain, the income would be U.S. sourced if the services are provided in the United States. Accordingly, the determination will hinge on whether the validation activities are performed in the United States or abroad. For delegated stakers who take the position that they are not engaged in a USTB, this may create an incentive to select validators who clearly operate entirely outside of the United States. In many instances, however, it may be difficult to determine whether a validator to whom activities have delegated to is based in the United States or not. As previously discussed, income is treated as being U.S. sourced if the source of the amount cannot be determined at the time of payment. Unfortunately, it appears that where the location of the validator cannot be determined, this presumption may apply.

If instead the staking rewards could be construed as a royalty, then the income appears to be sourced depending on where the underlying property (*i.e.*, the stake cryptocurrency) is used. And if the staking rewards are viewed as "found property" akin to the treasure trove, then perhaps sourcing depends on the location of the payor. Sourcing in these contexts may not be entirely clear, and as noted above, if that is the case, the payments are presumed to be U.S. sourced.

If the immediate income characterization applies, staking rewards would constitute FDAP income (*i.e.*, gross income under Code Sec. 61) and if U.S. sourced would therefore be subject to 30 percent withholding (unless reduced or eliminated under a treaty) when received.[175] The later sale of staking rewards could then be excluded from FDAP income under the exception for capital gains (assuming the rewards tokens are capital assets). If, however, the staking rewards are not U.S. sourced (*e.g.*, all activities are conducted outside of the United States), then no withholding should apply.

If instead one concludes that the self-created property characterization is correct, it would appear that the staking reward is free from FDAP withholding as it does not constitute an item of gross income. It is also possible that all of the income recognized (later upon a sale, exchange, or other disposition) would be characterized as capital gain and therefore not subject to withholding.[176]

V. Part Four: U.S. Federal Income Tax Consequences—U.S. Tax-Exempt Investors

Certain entities otherwise exempt from tax, including Code Sec. 501(c) organizations such as charities, colleges and universities, private pension funds, private foundations, as well as qualified pension, profit-sharing, stock bonus plans, and individual retirement accounts, *can* be subject to tax in some scenarios on their so-called unrelated business taxable income ("UBTI").[177] Very generally, UBTI is defined as gross income derived from an unrelated trade or business, regularly carried on, less any deductions that are directly connected with that trade or business.[178] Therefore, there are essentially three requirements in this regard: (i) a trade or business, (ii) which is regularly carried on, and (iii) which is not substantially related to the organization's exempt purpose.

For example, if a museum (otherwise exempt from tax under Code Sec. 501(c)) runs a gift shop, it could well be that certain items it sells could generate UBTI, given that the museum gift shop quite likely constitutes a trade or business that is regularly carried on. The question therefore may be whether the "substantially related" requirement is met. Posters or cards depicting paintings displayed at the museum may be substantially related to the museum's exempt purpose, and therefore might not generate UBTI. But, other items, such as souvenirs of the city in which the museum is located, likely would not be substantially related, and therefore could generate UBTI. The basic idea or policy here is that if tax-exempt organizations could engage in unrelated businesses without paying tax, they would have a tremendous and unfair advantage over "real" commercial and tax-paying businesses.

UBTI can arise even if an exempt organization engages in these unrelated activities indirectly through a partnership.[179] Therefore, if an investment fund, classified as a partnership, generates income that is UBTI, then a partner in that fund that is an exempt organization can have UBTI and be subject to tax.

A. UBTI Exceptions

Certain passive investment income, however, does not give rise to UBTI. In particular, Code Sec. 512(b) provides that gains from the sale of property,[180] dividends, interest, rents, and royalties do not constitute UBTI. Payments with respect to securities loans also are exempt, but only if they meet the Code Sec. 1058 requirements as well as some additional requirements in Code Sec. 512(a)(5).

In the exempt organization (UBTI) context, it appears that the term "royalty" has the same meaning as it does for other income tax purposes.[181] However, it also appears that there is a body of law that has developed that is specific to exempt organizations, whereby the courts have held that royalty treatment may be permitted with respect to certain mailing list rentals and affinity credit card programs.[182] In addition, in the context of mining for mineral interests, it appears that income from such mineral interests may constitute a royalty (and therefore be excluded from the computation of UBTI by Code Sec. 512(b)(2)), but perhaps only where the owner of the interest is relieved of the operating costs associated with his interest (such as by the terms of an agreement with the operator).[183] However, royalties do not include payments for services rendered, and in some instances it may not be clear if a given payment is a royalty or for a service rendered, especially where the exempt organization develops or manages the property in question, or has control of the activities involved.

However, if an exempt organization borrows money to make an investment, or invests in a partnership that borrows money to make investments, then a portion of the gain or income from the otherwise passive investment (such as dividends, interest, capital gains, *etc.*) becomes taxable as UBTI as "unrelated debt-financed income."[184]

In the cryptocurrency space, and as mentioned above, the IRS is of the view that cryptocurrency is classified as property. Therefore, the exclusion from UBTI set forth in Code Sec. 512(b)(5) should apply to non-dealer gains from sales, exchanges, trades, and other dispositions involving cryptocurrencies. However, any gain derived from leveraged, including margined, investments in cryptocurrency (*i.e.*, "debt-financed property") would constitute UBTI.

More difficult questions arise (including especially in the cryptocurrency arena) where the income in question does not fit neatly within the Code Sec. 512(b) exception, given that these exceptions are fairly narrowly defined and specific. For example, certain investment returns technically might not constitute dividends, interest, royalties, or gains. Therefore, even though these investment returns may be thought of as "passive," it is not entirely clear that they are therefore exempt from UBTI.

In this regard, the regulations provide a "catch-all" of sorts, excluding from UBTI "other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner."[185] However, unless specifically determined by the IRS (*e.g.*, in a private letter ruling), it seems quite risky to rely on this Treasury Regulation to exclude the income simply because it is "passive."[186]

Before the exceptions in Code Sec. 512(b) come into play, one question is whether the activity giving rise to the income first needs to constitute a "trade or business" that is "regularly carried on?"[187] That is, if one can conclude that the exempt organization, or the investment fund in which it is investing, is simply functioning in a passive investor capacity and is not engaged in a trade or business, perhaps there is no need to invoke Code Sec. 512(b) to begin with in order to avoid UBTI?

The answer here is not entirely clear[188] and the IRS certainly does not share this view. Instead, it is quite clearly of the view that the specific exclusions in Code Sec. 512(b) should be construed narrowly.[189] Accordingly, many tax advisors therefore are not willing to rely on the theory that if one can conclude that the exempt organization is simply functioning in an investor capacity, there is perhaps no need to invoke Section 512(b) to avoid UBTI.

There is, however, some favorable legislative history that suggests that Congress did not intend for ordinary or routine investment activities of a Code Sec. 501(a) organization be treated as the conduct of an unrelated trade or business.[190] For example, in at least one instance the IRS was willing to look to this Congressional intent in concluding that investment income not specifically covered by Code Sec. 512(b) is exempt from UBTI.[191] But, it is not clear what level of comfort can be obtained in this regard.[192]

B. Summary—UBTI

As with FDAP discussed above, the distinction between the immediate income characterization and the self-created property characterization appears to be quite significant here.

With the immediate income characterization, the staking rewards likely constitute UBTI. In particular, if the exempt organization is engaged in self-staking directly or indirectly through an investment fund that self-stakes, there is a risk that the staking reward could be part of a service trade or business, regularly carried on, that is substantially unrelated to its exempt purpose.[193] Accordingly, in these scenarios the staking reward could constitute UBTI by reason of Code Sec. 512. Even in the delegated staking context, there is nonetheless a risk that the staking reward could be UBTI. Again, with respect to staking rewards, and as discussed above, the nature of such income is not entirely clear and the rewards likely do not qualify for the exemption in Code Sec. 512(b) as they are not specifically enumerated therein, unless they could be characterized as royalties. However, even if the upfront reward constitutes UBTI, the later sale of staking rewards could then be excluded from UBTI under the exception for certain gains from the sale of property as set forth in Code Sec. 512(b)(5).

If instead one concludes that the self-created property characterization is correct, it would appear that the staking reward does not constitute UBTI as it does not constitute an item of gross income. It is also possible that all of the income recognized (later upon a sale, exchange, or other disposition) would be characterized as gain income and therefore not subject to UBTI by reason of Code Sec. 512(b)(5).

VI. Conclusion

PoS blockchains are an important and growing part of cryptocurrency markets. Despite the importance of staking, there is no guidance directly addressing its tax treatment and it remains a topic mired in uncertainty.

There are generally two competing characterizations of staking rewards—the self-created property characterization and the immediate income characterization. As described in this article, the self-created property characterization is generally more taxpayer favorable than the immediate income characterization from a timing and character standpoint. The self-created property characterization also has the potential (in the delegated staking context) to reduce withholding taxes for foreign persons and UBTI for tax-exempt organizations. Thus, the self-created property characterization would seem to give taxpayers the best of all worlds. However, given the inconclusive resolution of the *Jarrett* case, it is not clear that this characterization is viable. It would also appear that the IRS is, at least at the moment, of the view that the immediate income characterization should apply.

In addition to the fundamental questions of timing and character, the tax treatment of staking activities must also consider whether staking activities constitute a trade or business as well as how staking income should be sourced. Although these questions are commonly relevant, they are not easy to answer, particularly in the context of cryptocurrency activities that defy easy analogy to existing forms of business.

Hopefully, further guidance on these fronts will be issued soon. However, until then, taxpayers will be left to grapple with the uncertain tax treatment on their own.

ENDNOTES

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[1] The Ethereum consensus layer was previously called ETH 2.0. A description of the reasons for the name change can be found on the Ethereum Foundation website, *ethereum.org/en/upgrades/*.

[2] In a recent news release, the IRS reminded taxpayers of their reporting and potential tax obligations from, among other things, making virtual currency transactions, which include the "receipt of new virtual currency as a result of mining and staking activities." IR-2022-45, Mar. 1, 2022. This appears to be the first time the IRS has formally acknowledged in published material the concept of staking.

[3] *E.g.*, Digicash and e-gold.

[4] For a description of the Bitcoin blockchain and its mechanics, *see* Bitcoin: A Peer-to-Peer Electronic Cash System, *bitcoin.org/bitcoin.pdf*.

[5] The Ethereum execution layer was formerly known as ETH 1.0.

[6] The rewards structure varies by blockchain and also over time. For example, in the Bitcoin blockchain the rate at which new bitcoin is created slows down over time. The reward for mining each block of bitcoin—which is done every 10 minutes—halves every 210,000 blocks. The current rewards system is expected to continue until the year 2140, when the proposed 21 million supply limit for bitcoin is reached. Thereafter, miners will be rewarded solely with transaction fees.

[7] *See* Bitcoin Energy Consumption Index, *digiconomist.net/bitcoin-energy-consumption/*.

[8] There are numerous "layer 2" solutions to this issue. A discussion of these solutions is beyond the scope of this article.

[9] Admittedly, the extent of these apparent advantages is a matter of some debate. In the view of some commentators, staking rewards make PoS models more prone to centralization because newly created cryptocurrency goes into the hands of existing cryptocurrency holders.

[10] *See, e.g.*, Compass Podcast, *Leaving Proof-of-Work*, featuring Ben Edgington (ConsenSys) and Tim Beiko (Ethereum Foundation) (describing PoW as 100 lines of code and PoS as 100,000 lines of code).

[11] A description of PoS as it is applied in the Ethereum consensus layer can be found at *ethereum.org/en/developers/docs/consensus-mechanisms/pos/*.

[12] A description of PoS as it is applied in Solana can be found at *solana.com/staking*.

[13] A description of PoS as it is applied in Tezos can be found at *wiki.tezos.com/learn/baking*.

[14] This rewards framework was implemented through Ethereum Improvement Proposal EIP-1559, available at *eips.ethereum.org/EIPS/eip-1559*.

[15] The amount of ETH created can vary. *See* Monetary Policy, *docs.ethhub.io/ethereum-basics/monetary-policy/*.

[16] A description of Solana's economics is available at *docs.solana.com/economics_overview*.

[17] The initial inflation rate is 8 percent and the disinflation rate is 15 percent. *See* Solana's Proposed Inflation Schedule, *docs.solana.com/inflation/inflation_schedule*.

[18] Open Tezos, *opentezos.com/tezos-basics/economics-and-rewards/*.

[19] The capital requirements are more significant. To be a validator on the Ethereum consensus layer, one must stake a minimum of 32 ETH. At the time of writing, that would have a value of over $80,000.

[20] A liquidity pool is a crowdsourced pool of cryptocurrencies locked in a smart contract. The pool provides liquidity in a decentralized exchange, enabling trades between the various assets on the exchange. Smart contracts are, at their essence, programs stored on a blockchain that run when predetermined conditions are met.

[21] These governance tokens, as the name suggests, permit their holders to participate in the management of the platform. Having value in their own right, they can also be traded.

[22] Other differences between yield farming and liquidity mining include the relative complexities of the two processes, as well as their risk and reward profiles (yield farming is generally thought of as riskier, but with the potential for a higher return).

[23] For a discussion of certain tax considerations associated with wrapped cryptocurrencies, *see* Ritter, Tompkins & Dalbey, *Wrapped Bitcoin—Two Sides of the Same (Bit)coin?*, J. Tax'n Financial Products, 18, 2 (2021).

[24] Notice 2014-21, IRB 2014-16, 938, Question and Answer #8.

[25] At the time of Notice 2014-21, IRB 2014-16, 938, staking had yet been fully developed, which perhaps explains why this Notice does not address staking. Presumably, the IRS could issue immediate guidance regarding staking by simply updating its cryptocurrency FAQs on its website.

[26] A detailed discussion of the technical basis for the self-created property characterization can be found in Abraham Sutherland, *Cryptocurrency Economics and the Taxation of Block Rewards*, 165 Tax Notes Federal 749 (Nov. 4, 2019); and Abraham Sutherland, *Cryptocurrency Economics and the Taxation of Block Rewards, Part 2*, 165 Tax Notes Federal 953 (Nov. 11, 2019).

[27] Reg. §1.61-4.

[28] Reg. §1.61-3(a).

[29] *See* Mattia Landoni & Abraham Sutherland, *Dilution and True Economic Gain From Cryptocurrency Block Rewards*, 168 Tax Notes Federal 1213 (Aug. 17, 2020).

[30] *See* David Shakow, *Taxing Bitcoin and Blockchains: What the IRS Told US (and Didn't)*, 166 Tax Notes Federal 241 (Jan. 13, 2020), for a further rebuttal of the newly created property theory, generally, and for examples of several other situations in which taxable income is artificially inflated.

[31] *See* Letter from David Schweikert, Bill Foster, Tom Emmer & Darren Soto to Commissioner Charles Rettig (Jul. 29, 2020), available at *schweikert.house.gov/sites/schweikert.house.gov/files/Final%20Proof%20of%20Stake%20IRS%20Letter%207.29.20.pdf* ("Similar to all other forms of taxpayer-created (or taxpayer-discovered) property—such as crops, minerals, livestock, artworks, and even widgets off the assembly line—these tokens could be taxed when they are sold.").

[32] No. 3:21-cv-00419 (M.D. Tenn.).

[33] *See* Memorandum in Support of United States' Motion to Dismiss, *available at* 2022 TNTF 41-22 (Feb. 28, 2022). *See also* Nathan Richman, *Government Wants Crypto Stakers to Look Elsewhere for Precedent*, 2022 TNTF 41-5 (Mar. 2, 2022).

[34] *See* Proof of Stake Alliance, *IRS Waves White Flag in Lawsuit Over Taxability of Cryptocurrency Staking Rewards*, *www.proofofstakealliance.org/wp-content/uploads/2022/02/POSA-Press-Release-Feb-3-2022.pdf* (describing the refund offer as "a sign that the IRS may no longer attempt to tax tokens created through staking" and stating, "The IRS doesn't just lay down in court, especially in cases that could affect millions of taxpayers on a very basic point of law. It means they've got a losing argument.").

[35] *See* Nathan Richman & Mary Browne, *Tax Pros Burst Overeager Cryptocurrency Community Bubble*, 174 Tax Notes Federal 1148 (Feb. 21, 2022).

[36] *See* Memorandum in Support of United States' Motion to Dismiss, available at 2022 TNTF 41-22 (Feb. 28, 2022) ("The grant of a refund for one taxpayer for one year is neither a prospective nor universal statement of IRS policy about the many individual items reported on a tax return for any given year. However, the Proof of Stake Alliance has claimed—in a press release featuring statements from the Jarretts' counsel—that 'the IRS may no longer attempt to tax tokens created through staking moving forward.' Because refunds are return-specific, taxpayer-specific, and year-specific, that statement is little more than speculation.") (citations omitted).

[37] *See* Code Sec. 61(a) and Reg. §1.61-14(a). ("In addition to the items enumerated in Code Sec. 61(a), there are many other kinds of gross income.") *See also Glenshaw Glass Co.*, SCt, 55-1 USTC ¶9308, 348 US 426 (1955).

[38] The recent news release, where IRS reminded taxpayers of their reporting and potential tax obligations from, among other things, making virtual currency transactions, includes the "receipt of new virtual currency as a result of mining and *staking* activities." IR-2022-45, Mar. 1, 2022, (emphasis added). One could argue that with mining the newly created bitcoin is self-created property, similar to a staking reward, and should therefore not be subject to immediate taxation. Note, however, that the IRS made no distinction in Notice 2014-21, IRB 2014-16, 938, between mining income that consists of transaction fees and mining income that consists of newly created bitcoin. This suggests that the IRS does not ascribe to the self-created property characterization.

[39] In the case of the Jarretts, the transaction fee component of the rewards tokens was *de minimis* ($0.17) and was not the focus of the refund claim. *See* Brief In Support of Taxpayer Joshua Jarrett's 1040-X Amended Return Claim for Refund (Jul. 31, 2020), *proofofstakealliance.org/wp-content/uploads/2022/02/Brief-of-Taxpayer-Jarrett-in-Support-of-Refund-Claim-July-31-2020.pdf*.

[40] *See* David Shakow, *Taxing Bitcoin and Blockchains: What the IRS Told US (and Didn't)*, 166 Tax Notes Federal 241 (Jan. 13, 2020) ("The receipt of tokens by a validator is a taxable event because the validator is acting to maintain the blockchain and the reward is being given as compensation for that activity. True, the reward is, in some sense, a result of the activity of the validator. But it is not a creation in the same sense that a work of art is the creation of the artist. An artist works to create the work of art, which is the direct and immediate result of the artist's efforts. The validator works to add transactions to the blockchain and maintain its integrity. It is the system that then creates the reward, which is given to the validator. As such, it is appropriate to conclude that it is taxable compensation to the validator.").

[41] *Id*.

[42] At its most fundamental level, a blockchain is an open-source software that various parties can choose to interact with if they choose. By its very design, the blockchain does not have an owner and no party controls it.

[43] *See Cryptocurrency: What's Next for Regulation and Compliance? (Transcript)*, 174 Tax Notes Federal 1493 (Mar. 14, 2022).

[44] *See, e.g.*, Reg. §1.61-14(a). *See also* Code Sec. 74.

[45] *Compare* Reg. §1.61-14(a) ("Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession."), *with* Reg. §1.61-3(a) ("In a … mining business, 'gross income' means the total sales, less the cost of goods sold ….").

[46] The term "interest" has been defined as the amount "one has contracted to pay for the use of borrowed money" and, similarly, as "compensation for the use or forbearance of money." *See Old Colony RR Co.*, 3 USTC ¶880, 284 US 552, 560 (1932), *Deputy v. DuPont*, SCt, 40-1 USTC ¶9161, 308 US 488, 498, 60 SCt 363 (1940), and *Kena, Inc.*, 44 BTA 217, 220–221, Dec. 11,776 (1941). Staking rewards do not appear to satisfy this definition. In addition, the typical staking arrangement, even in the delegated staking scenario, does not provide the repayment of a sum certain, and therefore is unlikely to create indebtedness. *See Estate of Mixon*, CA-5, 72-2 USTC ¶9537, 464 F2d 394, 404 (1972) ("The presence of a fixed maturity date indicates a fixed obligation to repay, a characteristic of a debt obligation."); *B.D. Gilbert*, CA-2, 57-2 USTC ¶9929, 248 F2d 399, 402 (1957) ("The classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof."); *W.S. Gilman*, CA-8, 2 USTC ¶801, 53 F2d 47, 50 (1931) ("The term indebtedness as used in the Revenue [A]ct implies an unconditional obligation to pay." (quotations omitted)). *See also* FSA 199940007 (Oct. 8, 1999) ("The presence of a sum certain payable at maturity is a sine qua non of debt treatment under the Code.").

[47] Code Sec. 1(h).

[48] Code Sec. 1211.

[49] For example, the Treasury Department and IRS have taken the position that only capital gains are eligible to be invested in a qualified opportunity zone. *See* Reg. §1.1400Z2(a)-1(b)(11)(i)(A).

[50] *See* Code Sec. 1222. In certain cases, not relevant to this article, there may be a "deemed" sale or exchange. *See, e.g.*, Code Secs. 1271(a)(1), 1234(a), and 1234A.

[51] *See* Code Secs. 64 and 65.

[52] *Cf.* Rev. Rul. 2019-24, IRB 2019-44, 1004 (hard fork income is ordinary because there is no sale or exchange); CCA 202114020 (Mar. 22, 2021) (similar). To the extent the immediate income characterization relies on treating staking rewards as payments for services, it is well settled that the receipt of property in exchange for services is ordinary income. *See* Notice 2014-21, IRB 2014-16, 938, Question and Answer #3; CCA 202035011 (Jun. 29, 2020).

[53] *See* Code Sec. 1221 (noting in particular that in many scenarios it appears that none of the exceptions in (a)(1) through (a)(8) apply, such that capital gain or loss seems possible).

[54] *See* discussion at note 48, above.

[55] *See, e.g.*, Unchained Podcast Episode 320, *Your 2021 Crypto Taxes: How to Handle NFTs, DAOs, Airdrops and More* (Feb. 15, 2022), at 44:00.

[56] In general, for a property to be included in inventory, the primarily for sale requirement, customer requirement, ordinary course requirement, and trade or business requirement must be satisfied. That is, the same four requirements (discussed below) must be satisfied. Therefore, the distinction between inventory property and dealer property may not be significant in this context.

[57] At various times, the courts have used certain "tests" or "factors" to help determine whether a given piece of property constitutes "property held primarily for sale to customers in the ordinary course of a taxpayer's trade or business." However, the courts have also cautioned against a tendency to myopically view the determination through the lens of factors or tests and have stressed the importance of an analysis grounded in the statutory text. *See Suburban Realty Co.*, CA-5, 80-1 USTC ¶9351, 615 F2d 171, 177 (1980) ("The ultimate inquiry in cases of this nature is whether the property at issue was 'property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.' In our focus on the 'tests' developed to resolve this question, we have on occasion almost lost sight entirely of the statutory framework.") (citations omitted); *F. Thompson*, CA-5, 63-2 USTC ¶9676, 322 F2d 122, 127 (1963) ("Essential as they are in the adjudication of cases, we must take guard lest we be so carried away by the proliferation of tests that we forget that the statute excludes from capital assets 'property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.'"). While the various factors and tests are discussed herein where relevant, the primary focus is on the statutory language itself.

[58] *See Girard Trust Corn Exchange Bank*, 22 TC 1343, Dec. 20,585 (1954), *acq.*, 1955-1 CB 4. *See also* FAA 20123201F (Jun. 18, 2012).

[59] *See Malat v. Riddell*, SCt, 66-1 USTC ¶9317, 383 US 569, 86 SCt 1030 (1966).

[60] *See, e.g., Hollywood Baseball Ass'n*, CA-9, 70-1 USTC ¶9251, 423 F2d 494 (1970), *cert. denied*, SCt, 400 US 848, 91 SCt 35 (1970). In that case, the taxpayer (a baseball club) held baseball player contracts for the dual purpose of carrying on its business of participating in professional baseball games and selling the player contracts to major league teams. Over a 10-year period, the taxpayer sold 224 such contracts and, during the two-year period before the one at issue, realized approximately $150,000 of profit from the sale of the contracts. The court noted that the taxpayer lost approximately $130,000 from the taxpayer's other activities. Because the primary driver of business profits was the sale of contracts, the contracts were viewed as held primarily for sale, because their secondary purpose (supplying players to play in baseball games) did not produce profits and could therefore not be described as the "primary" purpose in any economically rational sense.

[61] *See Chinook Inv. Co.*, CA-9, 43-2 USTC ¶9538, 136 F2d 984 (1943); *R.F. Brown*, CtCls, 70-1 USTC ¶9407, 426 F2d 355 (1970); *S.M. Wood*, CA-9, 91-2 USTC ¶50,432, 943 F2d 1048 (1991); *Stephens, Inc.*, CA-8, 72-2 USTC ¶9547, 464 F2d 53, 57 (1972) ("[I]t is well established that 'investor' status attaches to anyone, including a recognized 'dealer,' who acquires securities with the primary intent to profit from their income yield."). *See also* CCA 200817035 (Apr. 25, 2008) ("Securities are consistently treated by courts as held for investment and not primarily held for sale to customers where they are held primarily for their income yield.").

[62] *See* Revenue Act of 1934, 48 Stat. 680 (1934).

[63] *See Guardian Indus. Corp.*, 97 TC 308 fn. 2, Dec. 47,610 (1991), *aff'd in unpub. opin.*, CA-6 (1994) (the court, referring to the "to customers" requirement, stated that "[o]utside the dealer/trader area, the term has been given such a broad meaning that separate consideration of it would not assist [the Court] in describing the instant case"); *L.B. Arberg*, 94 TCM 215, Dec. 57,066(M), TC Memo. 2007-244 ("Dealers are those who are engaged in the business of buying and selling securities and whose business involves sales to customers .... Traders, like dealers, are engaged in the trade or business of selling securities, but they do so for their own account.").

[64] The similarities are underscored by the recent expansion of broker reporting to digital assets. *See* Code Sec. 6045(g)(3)(B)(iv).

[65] We also note that some commentators have argued the "to customers" requirement should have broader relevance. *See* Friedlander, *"To Customers": The Forgotten Element in the Characterization of Basis on Sales of Real Property*, 39 Tax L. Rev. 31 (1983).

[66] 16 TC 1026, Dec. 18,271 (Acq.) (1951).

[67] *Id.* at 1032-33.

[68] *Id*. *See also S. Marrin*, CA-2, 98-2 USTC ¶50,490, 147 F3d 147 (1998).

[69] *See Schafer v. Helvering*, SCt, 36-2 USTC ¶9537, 299 US 171, 57 SCt 171 (1936) ("The stocks in dispute were purchased for the firm's own account solely in expectation of a rise in the market, for sale to anyone at a profit, as distinguished from a purchase to create a stock of securities to take care of future buying orders in excess of selling orders." (quotations omitted)); GCM 34965 (Jul. 28, 1972) ("[A non-dealer] purchase was made to realize a gain on future appreciation of the securities rather than to replenish an inventory to meet the demands of customers."); CCA 200817035 (Apr. 25, 2008) ("[U]nlike a dealer, Taxpayer was not acquiring securities either before or after their reclassification as a source of supply for customers.").

[70] *See, e.g.*, Reg. §1.471-5 ("For the purposes of this section, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to gains and profits that may be derived therefrom.").

[71] *See also* CCA 201423019 (Jun. 6, 2014) ("In determining whether a taxpayer has customers, the courts have looked to how a taxpayer is compensated. The Courts in finding dealer status outside of Code Sec. 475 have looked to whether a taxpayer is paid for its services as an intermediary—as a market-maker.").

[72] *See also* Reg. §1.475(c)-1(a)(2)(ii), Ex. 1–3 (transactions driven by internal needs are not transactions with customers; transactions driven by counterparty demand are transactions with customers).

[73] *See Louisiana W. Lumber Co.*, 22 TC 954, Dec. 20,468 (1954); *W. T. Thrift*, 15 TC 366, Dec. 17,863 (Acq.) (1950).

[74] *See C.E. Friend*, CA-10, 52-2 USTC ¶9428, 198 F2d 285 (1952); *Lobello v Dunlap*, CA-5, 54-1 USTC ¶9234, 210 F2d 465 (1954); *L.R. Boomhower*, DC-IA, 48-1 USTC ¶9133, 74 FSupp 997 (1947); *Shearer v. Smyth*, DC-CA, 53-2 USTC ¶9599, 116 FSupp 230 (1953), *aff'd*, CA-9, 55-1 USTC ¶9395, 221 F2d 478 (1955); *Austin*, DC-TX, 53-2 USTC ¶9503, 116 FSupp 283 (1953); *H.C. Martin*, DC-GA, 54-1 USTC ¶9157, 119 FSupp 468 (1954).

[75] *Guardian Industries Corp.*, 97 TC 308, 318, Dec. 47,610 (1991), *aff'd*, CA-6, 21 F3d 427 (1994).

[76] Reg. §1.446-1(d)(2). *See also Reinach*, CA-2, 67-1 USTC ¶9274, 373 F2d 900 (1967).

[77] *M. King*, 89 TC 445, 466, Dec. 44,174 (1987).

[78] Reg. §1.167(a)-3(a).

[79] In the case of a letter, memorandum, or similar property, the asset is an ordinary asset under Code Sec. 1221(a)(3) if it is held by a taxpayer for whom such property was prepared or produced. An asset will also be ordinary under Code Sec. 1221(a)(3) if it is held by a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of the taxpayer whose personal efforts created the property or, in the case of a letter, memorandum, or similar property, the taxpayer for whom such property was prepared or produced.

[80] It is possible that other types of digital assets, such as nonfungible tokens ("NFTs"), could be property described in Code Sec. 1221(a)(3). However, these assets are not, to our knowledge, generally able to be staked.

[81] Revenue Act of 1950, Pub. L. No. 81-814, §210. According to the House Ways and Means Committee report to the Revenue Act of 1950, "When any person sells an invention or a book or other artistic work which is the product of his personal effort his income from the sale is taxed as ordinary income, ... (even if it was) the first time he may have engaged in such a trade or business." H.R. Rep. No. 81-2319, at 54 (1950), *reprinted in* 1950-2 CB 380.

[82] *See* Associated Press, *Eisenhower to Pay Tax as an 'Amateur' Writer*, The New York Times, Jun. 2, 1948. *See also EISENHOWER TAXES ON MEMOIRS CITED; Treasury Ruled He Could Pay 25% Capital Gains Rate as an Amateur Writer*, The New York Times, Sep. 28, 1952.

[83] *See, e.g., R.J. Herwig*, CtCls, 52-1 USTC ¶9351, 105 FSupp 384 (1952) (sale of copyright by amateur treated as the sale of a capital asset); *R.W. TeLinde*, 18 TC 91, Dec. 18,910 (1952), *acq.*, 1952-2 CB 3 (sale of copyright by amateur treated as the sale of a capital asset); *Goldsmith*, 1 TC 711, Dec. 13,017 (1943), *aff'd*, CA-2, 44-2 USTC ¶9365, 143 F2d 466 (1944), *cert. denied*, 323 US 774 (1944) (sale of copyright by a professional treated as the sale of ordinary property); *J.A. Fields*, 14 TC 1202, Dec. 17,698 (1950), *acq.*, 1950-2 CB 2, *aff'd*, CA-2, 51-1 USTC ¶9341, 189 F2d 950 (1951) (sale of copyright by a professional treated as the sale of ordinary property).

[84] The Revenue Act of 1969 extended the scope of Code Sec. 1221(a)(3) to exclude from capital asset classification a letter, memorandum, or similar property held by the creator, a person for whom such property was prepared or produced, and any person who has a carryover basis with respect to such property. Pub. L. No. 91-172, Title V, §514(a), 83 Stat. 643. The Tax Cuts and Jobs Act extended the scope of Code Sec. 1221(a)(3) to exclude from capital asset classification any patent, invention, model or design, or secret formula or process. Pub. L. No. 115-97, Title I, §13314(a), 131 Stat. 2133.

[85] *See* Jt. Comm. on Tax'n, *Description of Revenue Provisions Contained in the President's FY 2000 Budget Proposal,* JCS-1-99 (Feb. 22, 1999) (jet fuel is a supply for an airline); LTR 200728032 (Apr. 5, 2007) (Clean Air Act emission allowances are not supplies because they are not tangible assets).

[86] *See* Jt. Comm. on Tax'n, *Description of Revenue Provisions Contained in the President's FY 2000 Budget Proposal*, JCS-1-99 (Feb. 22, 1999).

[87] *See* Reg. §1.1221-2(c)(5)(ii) (1994), T.D. 8555, 59 FR 36360, 36365 (Jul. 18, 1994) ("if a taxpayer sells only a negligible amount of a noninventory supply, then, only for purposes of determining whether a transaction to hedge the purchase of that noninventory supply is a hedging transaction, the supply is treated as ordinary property").

[88] *Cf. S.J. Namyst*, 88 TCM 463, Dec. 55,806(M), TC Memo. 2004-263 (tools used in a trade or business are not supplies).

[89] LTR 200728032 (Apr. 5, 2007) (Clean Air Act emission allowances are not supplies because they are not tangible assets).

[90] Code Sec. 212 expenses are miscellaneous itemized deductions. *See* Code Sec. 67(b). The Tax Cuts and Jobs Act eliminated taxpayers' ability to deduct miscellaneous itemized deductions through 2025. *See* Code Sec. 67(g).

[91] SCt, 41-1 USTC ¶9233, 312 US 212, 217 (1941).

[92] *See also R.P. Groetzinger*, SCt, 87-1 USTC ¶9191, 480 US 23, 107 SCt 980 (1987).

[93] *J.P. Stanton*, CA-5, 68-2 USTC ¶9516, 399 F2d 326, 329 (1968) (internal citations omitted).

[94] *See, e.g.*, E. John Lopez, *Defining "Trade or Business" under the Internal Revenue Code: A Survey of Relevant Cases*, 11 Fla. St. U. L. Rev. 949 (1984); Levey, U.S. Taxation of Foreign Controlled Businesses ¶1.03 (Definition of "Trade or Business") (Warren, Gorham & Lamont); Sicular & Sobol, *Selected Current Effectively Connected Income Issues for Investment Funds*, 56 Tax Law 719 (2003).

[95] *Doggett v. Burnet*, CA-D.C., 3 USTC ¶1090, 65 F2d 191, 194 (1933).

[96] *Hillcone Steamship Co.*, 22 TCM. 1096, 1107, Dec. 26,265(M), TC Memo. 1963-220 (1963). *See also C.L. Hirsch*, CA-9, 63-1 USTC ¶9371, 315 F2d 731, 736 (1963).

[97] *See H.L. Sutherland*, 27 TCM 103, 104, Dec. 28,835(M), TC Memo. 1968-20 (1968).

[98] *See, e.g., A.S. Pitts*, 63 TCM. 1742, Dec. 47,914(M), TC Memo. 1992-13 (1992); *P.S. Mosesian*, 60 TCM. 419, 423, Dec. 46,782(M), TC Memo. 1990-415 (1990); *W.L. Ferrell*, 90 TC 1154, 1181, Dec. 44,834 (1988).

[99] *See, e.g., W.H. Worrell,* DC-TX. 66-1 USTC ¶9370, 254 FSupp 992, 995 (1966); *T. Sabelis*, 37 TC 1058, 1062, Dec. 25,390 (1962), *acq.*, 1962-2 CB 5.

[100] *See* Reg. §1.183-2(b).

[101] *See* Notice 2014-21, IRB 2014-16, 938, Question #9 (asking whether an individual who "mines" virtual currency as a trade or business is subject to self-employment tax).

[102] SCt, 41-1 USTC ¶9233, 312 US 213, 218, 61 SCt 475 (1941).

[103] *Id.*

[104] *L. Hazard*, 7 TC 372 Dec. 15,273 (1946), *acq.*, 1946-2 CB 3.

[105] *E.M.L. Neill*, 46 BTA 197, Dec. 12,251 (1942) (single property rented to single tenant who was responsible for operating the property and paying all taxes and insurance); *I.H. Grier*, DC-CT, 54-1 USTC ¶9268, 120 FSupp 395 (1954), *aff'd*, CA-2, 55-1 USTC ¶9184, 218 F2d 603 (1955) (rental of a single property to a single tenant for entire duration of ownership; maintenance generally handled by having tenant secure services and receive reimbursement); *E. Herbert*, 30 TC 26, Dec. 22,928 (1958), *acq.*, 1958-2 CB 6 (nonresident owned single building rented to single tenant where all activities with respect to property were tenant's responsibility); Rev. Rul. 73-522, 1973-2 CB 226 (triple net lease of a single property to a single tenant); LTR 8350008 (Aug. 23, 1983) (triple net lease of a single hotel property to a single tenant); *V. Balsamo*, 54 TCM 608, Dec. 44,211(M), TC Memo. 1987-477 (taxpayer inherited house and sold soon thereafter; taxpayer's "activities with respect to the premises as rental property were almost nonexistent").

[106] *See, e.g., C.P. Snell*, CA-5, 38-2 USTC ¶9417, 97 F2d 891, 893 (1938) ("one may carry on a business through agents whom he supervises").

[107] *See* Code Secs. 761 and 7701(a)(2).

[108] *See* Reg. §301.7701-1(a)(1).

[109] *See* Reg. §301.7701-1(a)(2).

[110] *Id.*

[111] *See W.O. Culbertson*, SCt, 49-1 USTC ¶9323, 337 US 734, 742 (1949).

[112] *See H.M. Luna*, 42 TC 1067, 1077-78, Dec. 26,967 (1964).

[113] *See R.S. Robinson*, 44 TC 20, Dec. 27,321 (1965), *acq.*, 1976-2 CB 1; *ACME Music Co.*, BC-DC-PA, 96-2 USTC ¶50,391, 196 BR 925 (1996); and Rev. Rul. 70-435, 1970-2 CB 100.

[114] *See* Reg. §§301.7701-1 and 301.7701-2.

[115] *See* David Shakow, *Taxing Bitcoin and Blockchains: What the IRS Told US (and Didn't)*, 166 Tax Notes Federal 241, 248 (Jan. 13, 2020).

[116] *See* Code Sec. 721.

[117] As discussed below, this may have negative tax consequences for both foreign persons and tax-exempt organizations that are treated as partners. However, this may be a benefit to U.S. taxable investors, for the reasons described herein.

[118] A "Non-U.S. Person" generally means a beneficial owner who is not a "U.S. Person" as defined in Code Sec. 7701(a)(30).

[119] *See generally* Sicular & Sobol, *Selected Current Effectively Connected Income Issues for Investment Funds*, 56 Tax Law. 719 (2003); Dennehy & Ehrlich, *A Primer on U.S. Taxation of Inbound Corporations*, 172 Tax Notes Federal 393 (Jul. 19, 2021).

[120] *See* Code Secs. 871(b) and 882(a).

[121] *See* Reg. §1.6012-1(b)(1)(i) (individuals); Code Sec. 6012(a)(2) and Reg. §1.6012-2(g)(1) (corporations).

[122] *See* Code Sec. 884(a).

[123] Note that the rules governing taxation under the USTB regime take priority over the FDAP withholding rules. *See* Code Secs. 871(a)(1) and 881(a), which both provide that FDAP withholding applies "only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States."

[124] *See* Code Secs. 871(a) and 881(a).

[125] *See* Code Secs. 1441 and 1442.

[126] The regulations provide that whether a person is engaged in a trade or business in the United States is determined on the basis of the facts and circumstances in each case. *See* Reg. §1.864-2(e).

[127] *See* Code Sec. 864(b).

[128] *See* Code Sec. 864(b)(2).

[129] *See, e.g.*, Rev. Rul. 88-3, 1988-1 CB 268 (the rules for determining whether a foreign person is engaged in a USTB under Code Sec. 864(b) and the regulations promulgated thereunder "may differ in some respects from those used in determining whether a taxpayer is engaged in a trade or business under other sections of the Code.").

[130] *J. C. Lewenhaupt*, 20 TC 151, 163, Dec. 19,606 (1953), *aff'd*, CA-9, 55-1 USTC ¶9339, 221 F2d 227 (1955). *See also Pinchot*, CA-2, 40-2 USTC ¶9592, 113 F2d 718, 719 (1940); *I. de Amodio*, 34 TC 894, 906, Dec. 24,315 (1960), *aff'd*, CA-3, 62-1 USTC ¶9283, 299 F2d 623 (1962); and *Spermacet Whaling & Shipping Co.*, 30 TC 618, 634, Dec. 23,035 (1958), *aff'd*, CA-6, 60-2 USTC ¶9645, 281 F2d 646 (1960).

[131] For this reason, the IRS generally will not issue a private letter ruling on whether a taxpayer is engaged in a USTB. *See* Rev. Proc. 2022-7, §4.01(3).

[132] *See* Code Sec. 875. In these circumstances the partnership may have a withholding responsibility under Code Sec. 1446.

[133] *See Adda*, 10 TC 273, Dec. 16,244 (1948), *aff'd*, CA-4, 49-1 USTC ¶9109, 171 F2d 457 (1948); *I. de Amodio*, 34 TC 894, Dec. 24,315 (1960); *InverWorld, Inc.*,

71 TCM 3231, 3237-20, Dec. 51,428(M), TC Memo. 1996-301 (1996), *reconsideration denied*, 73 TCM 2777, Dec. 52,045(M), TC Memo. 1997-226 (1997); Rev. Rul. 70-424, 1970-2 CB 150; and Rev. Rul. 55-617, 1955-2 CB 774.

[134] *See E. Higgins*, SCt, 41-1 USTC ¶9233, 312 US 212, 218, 61 SCt 475 (1941).

[135] *See Di Portanova*, CtCls, 82-2 USTC ¶9598, 690 F2d 169 (1982) (ownership of a fractional working interests in oil and gas properties did not cause a foreign person to be engaged in a USTB where extensive control over operations was delegated to an independent management company).

[136] *See* Code Sec. 864(b)(2)(A). Note that trading in stocks and securities for the taxpayer's own account is defined very broadly in the regulations as the "effecting of transactions" in stocks and securities, which essentially means buying, selling, or trading as well as any other activity closely related thereto. *See* Reg. §1.864-2(c)(2).

[137] *See* Code Sec. 864(b)(2). As discussed above, whether one is a dealer is a facts and circumstances question, with operative question being how one intends to make a profit. For most investment funds, they are either investors or traders—that is, they buy stock, securities, or commodities for their own account, and profit if such assets appreciate in value. It is also worth noting that the Code Sec. 864(b) safe harbor generally is construed narrowly to exclude loan "origination" activities—the thinking is that if a foreign person is originating debt or loans, then that activity begins to look like a "lending" trade or business that is outside the scope of the safe harbor. Recently, the Large Business and International Division ("LB&I") Division within the IRS initiated a compliance campaign in this USTB lending area.

[138] *See* Code Sec. 864(b) and Reg. §1.864-2(a). A *de minimis* exception is available for certain personal services performed by a nonresident alien individual for a foreign employer. *See* Code Sec. 864(b)(1) and Reg. §1.864-2(b).

[139] *See InverWorld*, 71 TCM 3231, Dec. 51,428(M), TC Memo. 1996-301.

[140] *See I. Johansson*, CA-5, 64-2 USTC ¶9743, 336 F2d 809 (1964); *Van Der Elst*, CA-2, 55-1 USTC ¶9520, 223 F2d 771 (1955); *Ingram v. Bowers*, CA-2, 3 USTC ¶915, 57 F2d 65 (1932); Rev. Rul. 74-453, 1974-2 CB 19; Rev. Rul. 71-125, 1971-1 CB 358 (journalist's services); and Rev. Rul. 58-144, 1958-1 CB 260.

[141] *See* Code Sec. 861(a)(3).

[142] *See* Code Sec. 862(a)(3).

[143] *See Piedras Negras Broadcasting Co.*, 43 BTA 297, Dec. 11,616 (1941), *nonacq.*, 1941-1 CB 18, *aff'd*, CA-5, 42-1 USTC ¶9384, 127 F2d 260 (1942); and *Hawaiian Philippine Co.*, CA-9, 39-1 USTC ¶9263, 100 F2d 988 (1939).

[144] There are various provisions in the Code and the regulations that govern transaction that may be similar to or provide further analogies relevant to staking and cryptocurrency transactions, including those related to space and ocean activities set forth in Code Sec. 863(d)(1)(B), international communications income set forth in Code Sec. 863(e), and rules governing software related transactions, including those set forth in Reg. §1.861-18. A discussion of these rules is beyond the scope of this article.

[145] *See, e.g.*, Code Sec. 7701(e).

[146] *US Taxation of Cross-Border Enterprise Services*, Bulletin for International Taxation, Apr./May 2012.

[147] *See* Reg. §1.864-4(c)(6). *See also* Code Secs. 864(c)(2) and 864(c)(6).

[148] For example, capital gains from the sale of stock in U.S. portfolio companies generally are not subject to U.S. tax unless the disposed U.S. stock is considered a "U.S. real property interest" ("USRPI") under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). *See* Code Sec. 897. Under the FIRTPA rules a foreign person effectively is treated as engaged in a USTB, with corresponding gains and loss treated as ECI. *See also* Code Sec. 871(a)(2), which can cause certain nonresident alien individuals present in the United States for 183 days or more during the taxable year to be subject to a 30 percent tax on gains in certain cases.

[149] *See* Code Sec. 864(c)(2) and Reg. §1.864-4(c)(2) and (3). For other amounts (*i.e.*, other than U.S.-sourced FDAP and exempt gains), a general "force of attraction" concept applies. *See* Code Sec. 864(c)(3) and Reg. §1.864-4(b).

[150] *See* Reg. §1.864-4(c)(2)(i).

[151] *See* Reg. §1.864-4(c)(3)(i).

[152] *See* Reg. §1.864-4(c)(5).

[153] As noted above, on certain blockchains a portion of the reward tokens are specifically denoted as "transaction fees," and in those cases, it may be especially difficult to argue that this portion of the reward tokens is not ECI given that it appears to be paid as compensation for services.

[154] *See* Reg. §1.864-4(c)(2).

[155] Note that a similar result could follow where a foreign person takes a position that there is no USTB on account of staking activities that later proves to be incorrect.

[156] There are several exceptions applicable to interest income, including for "portfolio interest" as set forth in Code Secs. 871(h) and 881(c), interest paid on certain deposits as set forth in Code Sec. 871(i)(3), and original issue discount on instruments with a maturity of 183 days or less as provided in Code Sec. 871(g)(1)(B).

[157] *See* Code Secs. 871(a) and 881(a).

[158] *See* Reg. §§1.871-7(b) and 1.881-2(b). *See* discussion above regarding the definition of a "royalty."

[159] *See* Reg. §1.871-7(b)(1).

[160] *See* Reg. §1.1441-2(b)(1)(i). The regulations further note that the term FDAP is merely descriptive of the character of a class of income; that is, the item of income can still be FDAP whether made in a series of payments, or in a single lump sum, or whether paid annually or periodically (*i.e.*, from time to time). Reg. §1.1441-2(b)(1)(ii). In addition, an item of income is "fixed" when it is to be paid in amounts definitely pre-determined, and it is "determinable" if the amount to be paid is not known but there is a basis of calculation by which the amount may be ascertained at a later time. That is, an amount of income does not have to be determined at the time that the payment is made in order to be determinable. Reg. §1.1441-2(b)(1)(iii).

[161] For example, alimony, commissions, prizes, certain gambling winnings, and income on the surrender of life insurance policies have all held to be FDAP.

[162] Kuntz, Peroni & Bogdanski, U.S. International Taxation, ¶C2.03[9][d] (Warren, Gorham & Lamont).

[163] *See* Reg. §1.1441-2(b)(2)(i). Certain gains on the sale of intellectual property can be subject to withholding tax. *See* Reg. §1.1441-2(c). In addition, foreign persons who are individuals and who are physically present in the United States for at least 183 days during a taxable year can likewise be subject to withholding tax on certain U.S.-sourced gains. *See* Code Sec. 871(a)(2).

[164] *See* Code Secs. 861–865.

[165] *See* Code Sec. 861(a)(1).

[166] *See* Code Sec. 861(a)(2).

[167] *See* Code Sec. 861(a)(3).

[168] *See* Code Sec. 862(a)(3).

[169] *See* Code Sec. 865(a). Certain exceptions apply to inventory, depreciable personal property, and intangible property.

[170] *See* Code Secs. 861(a)(4) and 862(a)(4).

[171] *See, e.g., Sax Rohmer*, 14 TC 1467, Dec. 17,734 (1950); *Sanchez*, CA-2, 47-1 USTC ¶9297, 162 F2d 58 (1947), *aff'g* 6 TC 1141, Dec. 15,169, (1946), *cert. denied*, 332 US 815 (1947); *P.G. Wodehouse*, CA-4, 50-1 USTC ¶9123, 178 F2d 987, 991 (1949); *Molnar*, CA-2, 46-1 USTC ¶9303, 156 F2d 924, 926 (1946); and FSA 200222011 (May 31, 2002). *See also* Sprague & Determann, *Source of Royalty Income and Place of Use of Intangible Property*, 36 TAX MGMT. INT'L J. 351 (Aug. 10, 2007); and Guruli, *International Taxation: Application of Source Rules to Income from Intangible Property*, HOUSTON BUSINESS TAX LAW J. (2005).

[172] *See* Rev. Rul. 89-67, 1989-1 CB 233.

[173] *See Bank of Am.*, CtCls, 82-1 USTC ¶9415, 680 F2d 142, 230 ClsCt 679 (1982).

[174] *See* Reg. §§1.1441-2(a) and 1.1441-3(d)(1). The regulations also note that the fact that the source of an item of income cannot be determined at the time that the payment is made does *not* render a payment "not determinable" for purposes of whether the amount constitutes FDAP. *See* Reg. §1.1441-2(b)(iii).

[175] Note that many income tax treaties with the United States have a so-called "other income" provision that could apply in this scenario. A discussion of income tax treaties is beyond the scope of this article.

[176] If the staking rewards are not capital assets, gain would likely be sourced to the residence of the seller under the general rules for personal property sales. *See* discussion at note 169.

[177] *See* Code Sec. 511. Generally, the tax is imposed at regular corporate rates.

[178] *See* Code Secs. 512 and 514.

[179] *See* Code Sec. 512(c).

[180] Gains, however, are not exempt from tax if they are a result of "dealer"-type activity. Therefore, gains from inventory or property held primarily

for sale to customers in the ordinary course of a trade or business are not exempt.

[181] Again, to be a royalty, a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes. *See, e.g.*, Rev. Rul. 81-178, 1981-2 CB 135; and *P.G. Wodehouse*, SCt, 49-1 USTC ¶9310, 337 US 369, 69 SCt 1120 (1949).

[182] *See, e.g., Disabled American Veterans*, CtCls, 81-1 USTC ¶9443, 650 F2d 1178, 1185-89 (1981), *aff'g in part, rev'g in part, and remanding*, CtCls, 80-2 USTC ¶9568 (1980); *Sierra Club, Inc.*, 77 TCM 1569, Dec. 53,299(M), TC Memo. 1993-199, *aff'd*, CA-9, 96-2 USTC ¶50,326, 86 F3d 1526 (1996); and *Sierra Club, Inc.*, 103 TC 307, Dec. 50,080 (1994), *rev'd and remanded*, CA-9, 96-2 USTC ¶50,326, 86 F3d 1526 (1996), *on remand*, 77 TCM 1569, Dec. 53,299(M), TC Memo. 1999-86.

[183] *See* Reg. §1.512(b)-1(b) ("Mineral royalties shall be excluded whether measured by production or by gross or taxable income from the mineral property. However, where an organization owns a working interest in a mineral property, and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded."). *See also* Rev. Rul. 69-179, 1969-1 CB 158.

[184] *See* Code Sec. 514 (which provides that a specified portion or percentage is to be treated as UBTI, based on a fraction/formula).

[185] *See* Reg. §1.512(b)-1(a)(1). Note that the exception applies only "to the extent determined by the Commissioner."

[186] *See* Andrew Walker, *Investments in Derivatives Could Face Tax as an Unrelated Business*, Tax'n Exempts [formerly J. Tax'n Exempt Organizations] (WG&L), May/Jun. 2002.

[187] In this regard, the requirement of a "trade or business" is, as noted above, one of the three requirements to have UBTI as set forth in Code Sec. 512(a)(1).

[188] *See* Walker, *supra* note 186.

[189] *See, e.g.*, the Preamble to Reg. §1.512(a)-6, at T.D. 9933, 85 FR 77952 (Dec. 2, 2020).

[190] *See* S. Rep. No. 81-2375, available at 1950-2 CB 483 (which talks of exempting "similar items").

[191] *See* Rev. Rul. 78-88, 1978-1 CB 163 ("This legislative history of Code Sec. 512(b)(5) indicates that Congress does not intend for ordinary or routine investment activities of a Code Sec. 501(a) organization in connection with its securities portfolio to be treated as the conduct of a trade or business for purposes of Code Sec. 513."). Interestingly, both Reg. §1.512(b)-1(a)(1) and the legislative history have concepts of "ordinary" and/or "routine" investment activities, and one open item may be whether activities in the cryptocurrency arena, which is quite new and developing, can meet this standard.

[192] *See* Walker, *supra* note 186 ("Accordingly, exempt organizations that are considering novel derivatives but cannot seek a private ruling must rely on the uncertain comfort of the trade or business exception and Congressional intent to exempt such income reflected in the legislative history.").

[193] Again, and as noted above, on certain blockchains a portion of the reward tokens are specifically denoted as "transaction fees," and in those cases, it may be especially difficult to argue that this portion of the reward tokens is not UBTI given that it appears to be paid as compensation for services.

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