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**PROPOSED CLARIFICATION TO REVENUE RULING 2023-14 – INCLUSION OF
STAKING REWARDS AT THE TIME OF RECEPTION – AND GUIDANCE THAT
WRAPPING IS NOT A TAXABLE EVENTS
(Rev. Rul. 2023-14)**

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A. Introduction

This paper examines and proposes clarifications regarding the tax treatment of two common cryptocurrency activities: staking rewards and wrapping tokens.

The objective is to provide clearer guidance and address ambiguities in Revenue Ruling 2023-14, which asserts that staking rewards constitute taxable income upon receipt. Additionally, this paper advocates the position that wrapping tokens does not constitute a taxable event.

According to Revenue Ruling 2023-14, a cash-method taxpayer staking a cryptocurrency native to a proof-of-stake blockchain and receiving additional units as a reward for validation actions must include the fair market value of the rewarded unit in the taxpayer's

gross income in the taxable year when the taxpayer gains dominion and control over the validation reward. The ruling also applies if the taxpayer stakes through a cryptocurrency exchange.

The Revenue Ruling does not specify when a taxpayer gains dominion and control, nor does it clarify if the concept of “constructive receipt” applies. Of particular significance is the application of the constructive receipt doctrine to pool staking, where additional units may be constructively received when the pool, rather than the taxpayer, obtains them. This paper seeks clarification that the concept of constructive receipt does not apply.

In connection with staking rewards, the paper seeks guidance on whether the wrapping and unwrapping of staked cryptocurrencies to a tradable form constitute taxable events. The guidance should adopt a broad perspective and classify wrapping in general as a non-taxable event, even if done for economic reasons.

B. Background

This paper focuses on two fundamental transactions in the world of digital assets: (1) Staking, especially Liquidity Staking, and the related concept of (2) Wrapping. Before analyzing the existing legal framework and the rationale for the proposed changes, it is important to explain both staking and wrapping.

The Liquidity Staking Market was the fastest-growing decentralized finance (“DeFi”) activity in tax year 2023. One of the leading cryptocurrency information websites, Coindesk, reported on November 29, 2023, that \$26 billion was deposited into liquidity staking token protocols, making it the largest category in the DeFi sector.¹ Well known liquidity staking platforms include Lido (supporting Ethereum, Polygon, and Solana blockchains), Coinbase Prime, Rocket Pool, Frax Ether, Stake Wise, Binance (all Ethereum), Marinade Finance (Solana), or Ankr (Ethereum, BSC, Polygon, Fantom, Avalanche, Kusama, and Gnosis).

For the purpose of this paper, a platform typically refers to a digital infrastructure or network that allows developers to build decentralized applications or smart contracts. These platforms often utilize blockchain technology to facilitate secure and transparent transactions without the need for intermediaries.

Platforms usually provide a set of tools, protocols, and sometimes even their own native cryptocurrencies, which serve various purposes within the ecosystem. They enable users

¹ <https://www.nasdaq.com/articles/liquid-staking-tokens-are-a-hot-ticket-for-2024>, last accessed 2/28/2024 at 8:02am.

to create, deploy, and interact with decentralized applications, offering functionalities such as token creation, DeFi services, identity verification, and more.

A “network” refers to the interconnected system of nodes (computers or servers) that communicate with each other to maintain and operate the blockchain protocol. These nodes can be distributed across the globe and work together to validate transactions, secure the network, and maintain the integrity of the blockchain ledger. The network facilitates the peer-to-peer transmission of data and transactions, enabling participants to interact with the blockchain and engage in activities such as sending and receiving cryptocurrencies, executing smart contracts, and participating in decentralized applications.

A “protocol” refers to the set of rules and guidelines that govern the behavior and interactions within a blockchain network. These rules dictate how transactions are validated, how new blocks are added to the blockchain, and how consensus is reached among network participants. Essentially, the protocol defines the technical infrastructure and operational parameters of the blockchain, ensuring its security, transparency, and functionality.

1. Description of Staking

Double spending, where the same funds are spent more than once, is a longstanding challenge in digital transactions. Blockchain technology, however, has emerged as a revolutionary solution. By leveraging a decentralized ledger system, blockchains ensure that each transaction is verified and recorded securely, thus eliminating the risk of fraudulent duplicate transactions. Once an individual wants to transfer tokens, the wallet sends the transaction information to a pool of unconfirmed transactions, called the “Mempool.” A transaction is confirmed by being validated and recorded in a block. This block is set by a node² chosen through a consensus mechanism.

Central to this solution is the consensus algorithm, a method by which participants in a network agree on the system's state or the validity of transactions. An inherent reward system serves to incentivize users to sustain the operational protocols of a network and foster long-term engagement in the blockchain ecosystem. This consensus algorithm provides settlement assurance to a network, with the reward paid in the token native to the blockchain.³

² One user within a distributed group of computers or servers.

³ *Nic Carter*, “It’s th settlement assurances, stupid” (July 22, 2019), available at https://medium.com/@nic__carter/its-the-settlement-assurances-stupid-5dcd1c3f4e41.

The predominant consensus algorithms are currently proof of work and proof of stake.⁴ The proof of work requires the nodes to solve a computationally challenging mathematical problem. The node that solves this problem first, known as the miner, sets the block and receives the reward for the block, known as mining.⁵ Proof of stake involves individuals putting their cryptocurrency holdings at stake, known as staking.

Staking entails individuals staking their cryptocurrency holdings, with those possessing larger stakes having greater odds of being chosen to validate the next block's transactions. This process, akin to a lottery system, confers additional cryptocurrency rewards to validators, thereby bolstering network security and fostering long-term engagement in the blockchain ecosystem.⁶

A validator who puts his capital in the form of Ether at risk, "stakes" it. In case they act dishonestly, some or all of the staked Ether can be destroyed, called slashing.⁷ If the validator, for example, fails to validate a block when chosen, makes an incorrect attestation to the transactions he validates, or he is signing to blocks at the same time instead of one, his stakes can be slashed.

During this staking period, token holders cannot transfer, sell, or trade their assets, rendering them temporarily illiquid. The rewards earned through direct staking depend on factors such as the amount staked, the protocol, and prevailing market conditions for the cryptocurrency involved.⁸ Validators can withdraw their stakes along with earned rewards after completing certain cycles (known as the "unbonding period").⁹

A user might decide that they are not familiar or capable enough to run the risk of inadvertently making mistakes or leaving dedicated hardware online around the clock during the validation process, which could result in their stakes being slashed. Instead,

⁴ Others being Proof-of-Work (utilized by, for example, the Bitcoin blockchain), Delegated Proof of Stake (Tron), Proof of Reputation (U2U Chain), and others being Proof of Burn, Proof of History, Proof of Elapsed Time, etc.

⁵ Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System (Oct. 31, 2008), available at <https://bitcoin.org/bitcoin.pdf>.

⁶ For a detailed description for the example of the Tezos network, see Brief in Support of Taxpayer Joshua Jarrett's 1040-X Amended Return and Claim for Refund by counsel for taxpayer Abraham Sutherland (July 31, 2020), pp. 6-9, available under <https://static1.squarespace.com/static/62f147feb8108a08e666aea5/t/63127d123ecc7346d75c3963/1662156052488/Brief-of-Taxpayer-Jarrett-in-Support-of-Refund-Claim-July-31-2020.pdf>, last accessed 2/21/2024, at 1:29pm (PST).

⁷ <https://ethereum.org/developers/docs/consensus-mechanisms/pos>, last accessed 2/21/2024 at 1:48pm.

⁸ For a detailed description of the process described on the example of staking on the Tezos network, Sutherland, Abraham, Joshua Jarrett's 8,876 New Tezos Cryptocurrency Reward Tokens Are Not Taxable Income: Brief in Support of Jarrett's Amended Return and Claim for Refund (July 31, 2020). Available at SSRN: <https://ssrn.com/abstract=4311624> or <http://dx.doi.org/10.2139/ssrn.4311624>.

⁹ See <https://ethereum.org/staking/withdrawals#staking-rewards>.

users can opt to delegate their tokens to a staking pool or use a Staking as a Service provider, known as SaaS.

2. Liquidity Staking

Combined stakes increase the chances of being the validator for the next block. Pooled funds are more likely to be chosen than every single user of this pool would be.¹⁰ The user contributes funds to a “staking pool” that is associated with a certain delegate, known as witness. The earned rewards are then returned to the stakeholders of the pool.¹¹

The pools often include what is known as “liquid staking.” When transferring tokens to a pool with a staking designation, users may receive some form of a Liquidity Staking Token (“LST”) in return. These LSTs can be traded or used as collateral for loans while the initial token is locked up for validation and earning rewards.¹² Liquid staking streamlines the process of exiting and offers the convenience of staking akin to a token swap, enabling users to easily convert their staked assets back into a liquid form at any time. Additionally, this option empowers users to retain custody of their assets within their wallets.¹³

The counterparty providing the LST is either a smart contract (“Protocol Model”) or a SaaS provider (“Provider Model”).¹⁴

In the Protocol model, the user allocates his assets to a smart contract protocol, which subsequently stakes these assets on the user’s behalf. The user receives an LST, basically as a Receipt. Each Receipt Token serves as a digital representation of ownership of the staked assets, generated and managed entirely through smart contract

¹⁰ Parma Bains, Blockchain Consensus Mechanisms: A Primer for Supervisors, International Monetary Fund (Jan. 26, 2022), p.12, available at <https://www.imf.org/en/Publications/fintech-notes/Issues/2022/01/25/Blockchain-Consensus-Mechanisms-511769>, last accessed 2/21/2024, at 2:07pm.

¹¹ Parma Bains, Blockchain Consensus Mechanisms: A Primer for Supervisors, International Monetary Fund (Jan. 26, 2022), p.12, available at <https://www.imf.org/en/Publications/fintech-notes/Issues/2022/01/25/Blockchain-Consensus-Mechanisms-511769>, last accessed 2/21/2024, at 2:07pm.

¹² <https://www.ledger.com/academy/pooled-staking-how-crypto-staking-pools-work>; last accessed 12/27/2023 at 2:24 pm (PST).

¹³ See for Ethereum: <https://ethereum.org/staking#how-to-stake-your-eth>. Ethereum transitioned from a proof-of-work to a proof-of-stake consensus mechanism on September 15, 2022, see The Merge, Ethereum Foundation, available at <https://ethereum.org/roadmap/merge>, last accessed on 2/26/2024 at 4:22pm.

¹⁴ See Proof of Stake Alliance, U.S. Federal Securities and Commodity Law Analysis of Liquid Staking Receipt Tokens, p. 6, available at <https://static1.squarespace.com/static/62f147feb8108a08e666aea5/t/63f41766f6095b07bec7d1e8/1676941158721/U.S.+Federal+Securities+and+Commodity+Law+Analysis+of+Liquid+Staking+Receipt+Tokens+%28Willkie+Draft+02.14.23%29.pdf>

code without the involvement of intermediaries.¹⁵ The Proof of Stake Alliance compared this arrangement with a bailment relationship, “[a] bailment relationship is said to arise where an owner, while retaining title, delivers personally to another for some particular purpose upon an express or implied contract. The relationship includes a return of the goods to the owner or a subsequent disposition in accordance with his instructions.”¹⁶

In the Provider Model, a user establishes a direct relationship with a SaaS provider, typically a centralized exchange, and the relationship is governed by a services agreement. Here, users deposit their assets into the provider's digital wallet, and the provider undertakes the staking process on the user's behalf. Upon deposit or request, the provider issues Receipt Tokens representing ownership of the staked assets to the user and stands ready to redeem these tokens for the corresponding assets, with adjustments made for rewards or losses, upon presentation by the user.¹⁷

Both models involve a relationship akin to a bailment, a legal concept where one party temporarily entrusts goods to another. In this context, the Liquid Staker is akin to the bailor, while the protocol or service provider acts as the bailee.¹⁸

Whether it is a Protocol Model or a Provider Model, both arrangements accrue staking rewards (and potential slashing losses) in either static or dynamic way. In Static Receipt Tokens the ownership is represented by Receipt Tokens that adjust in quantity as these rewards or losses occur. In the Dynamic Receipt Tokens, the gain or loss of additional Receipt Tokens is reflected in the increase or loss in the value of the LST but the quantity of LST remains the same. Despite these differences, investors can always exchange their

¹⁵ See Proof of Stake Alliance, U.S. Federal Securities and Commodity Law Analysis of Liquid Staking Receipt Tokens, p. 6, available at <https://static1.squarespace.com/static/62f147feb8108a08e666aea5/t/63f41766f6095b07bec7d1e8/1676941158721/U.S.+Federal+Securities+and+Commodity+Law+Analysis+of+Liquid+Staking+Receipt+Tokens+%28Willkie+Draft+02.14.23%29.pdf>

¹⁶ *Lionberger v. United States*, 371 F.2d 831, 840 (Ct. Cl. 1967).

¹⁷ See Proof of Stake Alliance, U.S. Federal Securities and Commodity Law Analysis of Liquid Staking Receipt Tokens, p. 6, available at <https://static1.squarespace.com/static/62f147feb8108a08e666aea5/t/63f41766f6095b07bec7d1e8/1676941158721/U.S.+Federal+Securities+and+Commodity+Law+Analysis+of+Liquid+Staking+Receipt+Tokens+%28Willkie+Draft+02.14.23%29.pdf>

¹⁸ See Proof of Stake Alliance, U.S. Federal Securities and Commodity Law Analysis of Liquid Staking Receipt Tokens, p. 6, available at <https://static1.squarespace.com/static/62f147feb8108a08e666aea5/t/63f41766f6095b07bec7d1e8/1676941158721/U.S.+Federal+Securities+and+Commodity+Law+Analysis+of+Liquid+Staking+Receipt+Tokens+%28Willkie+Draft+02.14.23%29.pdf>

Receipt Tokens for the underlying assets, either directly or by transferring them to others, subject to blockchain-specific waiting periods.¹⁹

An example of a popular LST is cbETH,²⁰ available to users staking via the centralized exchange Coinbase. The Coinbase Wrapped Staked ETH (“cbETH”) represents the amount of Ether a user stakes through their Coinbase account and can be traded and unwrapped at any time.²¹

3. Wrapping

Wrapping a digital asset involves creating a representation of that digital asset on another blockchain or in a different format. This process typically results in the issuance of a token, often referred to as a wrapped token or wrapped asset, that mirrors the value of the original digital asset it is pegged to. The original cryptocurrency is frozen during the time the wrapped token is in existence.

The general purpose of wrapping is often to enable the use of a specific cryptocurrency on a blockchain that supports different standards or functionalities, such as decentralized finance (DeFi) applications, for example wrapping a bitcoin to use this bitcoin on the Ethereum blockchain. While a bitcoin on its native blockchain has only a single purpose, trading, a token on the Ethereum blockchain can fulfill multiple purposes. One reason why Ethereum allows for more than one purpose is the built in programming language (called “solidity”) that allows users to create a tool and send this tool to the blockchain, creating a smart contract.

There are two different forms of this: custodial and non-custodial.

Custodial tokens are like digital IOUs issued by a trusted company. The centralized, trusted entity holds the underlying asset (for example one Bitcoin) and mints a token that represents it on the blockchain. One example would be wBTC, one form of a wrapped bitcoin. The wBTC is a ERC-20 token, meaning it adheres to the technical standard of a fungible token on the Ethereum blockchain.²² The custodian is BitGo.²³ The smart

¹⁹ Proof of Stake Alliance, U.S. Federal Income Tax Analysis of Liquid Staking, p. 5, available at [https://static1.squarespace.com/static/62f147feb8108a08e666aea5/t/63f3fd27f0b0fc45f7d906c2/1676934439845/U.S. Federal Income Tax Analysis of Liquid Staking.pdf](https://static1.squarespace.com/static/62f147feb8108a08e666aea5/t/63f3fd27f0b0fc45f7d906c2/1676934439845/U.S.+Federal+Income+Tax+Analysis+of+Liquid+Staking.pdf), last accessed 2/26/2024 at 4:36pm.

²⁰ See <https://etherscan.io/token/0xbe9895146f7af43049ca1c1ae358b0541ea49704>. Besides Ethereum (ETH), Coinbase offers staking for the following assets Cardano (ADA), Cosmos (ATOM), Polkadot (DOT), Polygon (MATIC), Solana (SOL), and Tezos (TXZ). Other examples of LSTs are stETH on Lido, sETH2 on RocketPool, mSOL on Stake Wise, ETHx on Binance, etc.

²¹ <https://help.coinbase.com/en/coinbase/coinbase-staking/staking/wrap-unwrap-staked-eth>, last accessed 12/27/2023 at 2:30pm (PST).

²² See <https://ethereum.org/en/developers/docs/standards/tokens/erc-20/>.

²³ See <https://wbtc.network/dashboard/audit>.

contract minting the wBTC on the Ethereum blockchain is not automatic (or better permissionless), but has a minting authority.²⁴

Non-custodial tokens are more like smart contracts. They lock the real asset in a digital vault and mint a token that represents that asset. One example would be wETH,²⁵ one form of a wrapped ether. The functionality of wETH is a good example because of its simplistic mechanism. The taxpayer deposits ETH in the smart contract, the smart contract mints wETH. The ETH can only be redeemed by destroying the wETH (called burning).

C. Current Law

There is currently no statute, case law, or IRS guidance on point providing certainty whether using a smart contract (Protocol Model) or Saas (Provider Model) to stake and receive LSTs or to return LSTs and receive the underlying token, or similarly, whether wrapping a token, is a taxable event or not. The IRS has provided guidance on staking rewards.²⁶

1. Tax Implication of Staking Rewards

The tax implications of staking in general were not addressed until 2023, when on the heels of *Jarrett v. United States*²⁷, the IRS issued Rev. Rul. 2023-14.

In *Jarrett v. United States*,²⁸ the plaintiffs sought a refund based on the tax treatment of rewards received for direct staking. However, their case became moot when the government issued a refund instead of litigating the case on the merits. The plaintiffs argued that staking rewards were newly created property, akin to harvesting an apple or mining iron ore, and should, therefore, not be taxed until the rewards are sold. According to the argument, income would only be 'realized' under 26 U.S.C. § 61(a) on the sale of the awarded tokens.²⁹ Another argument posited that staking rewards are inflationary, implying no accession of wealth but merely an offset for the mitigated value of each token after additional tokens have been issued.³⁰ The latter argument says that staking is not a

²⁴ <https://etherscan.io/token/0x2260fac5e5542a773aa44fbcfedf7c193bc2c599#code>.

²⁵ See the full code here:

<https://etherscan.io/token/0xc02aaa39b223fe8d0a0e5c4f27ead9083c756cc2#code>.

²⁶ Rev. Rul. 2023-14 (July 31, 2023).

²⁷ *Jarrett v. United States*, 79 F.4th 675 (6th Cir. Aug. 18, 2023).

²⁸ *Jarrett v. United States*, No. 3:21-cv00419 (M.D. Tenn., Aug. 27, 2021).

²⁹ Argument based on *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431, 75 S.Ct. 473, 99 L.Ed. 483 (1955).

³⁰ See *Sutherland*, Phantom Income and the Taxation of New Cryptocurrency Tokens, Tax Notes posted on 1/30/2023, <https://www.taxnotes.com/featured-analysis/phantom-income-and-taxation-new-cryptocurrency-tokens/2023/01/27/7fv8n#7fv8n-0000043>, last accessed 12/31/2023 at 1:21pm. The author represents the plaintiffs in *Jarrett* together with Fenwick & West LLP and Consovoy McCarthy PLLC.

gain but the avoidance of loses. If the entire network has 100 tokens and 10 new tokens are being minted and rewarded to the stakers, the value of the 100 tokens is equal to the value of the 110 tokens. This is comparable to the pro rata dividend after a stock split which is not a taxable event.³¹

Approximately four months after the plaintiffs filed the complaint and after responding to the plaintiff's complaint, the government issued a refund check for the full amount at issue. The plaintiffs did not cash the check. On this basis, the District Court dismissed the case as moot.³² This dismissal was affirmed by the U.S. Court of Appeals on August 18, 2023.³³

The IRS formulated its official position that staking rewards are taxable at the time of receipt because the IRS views staking rewards as an exchange for goods or services. The first, more generic formulation of this position occurred in the update to the FAQs for Digital Assets published on the IRS's website on January 24, 2023, when the FAQ described the receipt of 'new digital assets resulting from mining, staking, and similar activities' as a taxable transaction.³⁴ Subsequently, in Revenue Ruling 2023-14, issued on July 31, 2023,³⁵ stating that a cash-method taxpayer staking a cryptocurrency native to a proof-of-stake blockchain and receiving additional units as a reward for validation actions must include the fair market value of the rewarded unit in the taxpayer's gross income in the taxable year when the taxpayer gains dominion and control over the validation reward. The Revenue Ruling determined that the 'rewards' generated through staking activities constituted taxable income, contributing to an increase in the taxpayer's gross income upon receipt. This applies for both direct staking and staking through an exchange."

The authors acknowledge that this is the current IRS position and in order to change this classification and accepts for the following arguments this position.

2. No Income Recognition for the Swap of Liquidity Staking Tokens except for the Reward Portion or Wrapping/Unwrapping³⁶

The IRS has yet to clarify whether wrapping or exchanging from an underlying token, such as ETH, to LST or vice versa constitutes a taxable event.

³¹ see <https://www.irs.gov/faqs/capital-gains-losses-and-sale-of-home/stocks-options-splits-traders/stocks-options-splits-traders-7>.

³² *Jarrett v. United States*, No. 3:21-cv-00419 (M.D. Tenn. Sep. 30, 2022).

³³ *Jarrett v. United States*, 79 F.4th 675 (6th Cir. Aug. 18, 2023).

³⁴ See <https://www.irs.gov/newsroom/irs-updates-to-question-on-digital-assets-taxpayers-should-continue-to-report-all-digital-asset-income>, last accessed on 12/27/2023 at 3:06pm (PST).

³⁵ See <https://www.irs.gov/pub/irs-drop/rr-23-14.pdf>, last accessed on 12/27/2023 at 3:08pm (PST).

³⁶ This is limited to the exchange through smart contracts or SaaS and does not apply to the trade, sale, or purchase of LST through other means.

It's crucial to differentiate between two scenarios: (1) the initial swap from a token to an LST, and the subsequent exchange back. The latter transactions involve two distinct components: the principal amount, representing the equivalent tokens originally exchanged into LST, and the reward portion, which could manifest as additional LST (Static Receipt Token) or additional original tokens received for the LST (Dynamic Tokens). Any losses incurred are similarly reflected in the quantity or value of the LST. Importantly, the relevant exchange rate is that between the underlying token and LST, not the dollar amount to LST, as fluctuations in the overall value of the underlying token can distort results.

While both transactions are similar to wrapping and unwrapping of a token, and therefore, will be treated in the same paragraph, it is worth noting that the unwrapping in other contexts does not result in an additional token reward other than in the context of Liquidity Staking.

a. Initial Exchange to LST/ Wrapping

The IRS and the Department of the Treasury have not issued guidance on whether the receipt of LSTs or wrapping is a taxable event. Both transactions pose a similar issue of whether or not it meets the requirement of being a sale or other disposition under IRC § 1001(a), Treas. Reg. § 1.1001-1.

Treas. Reg. § 1.1001-1 states, ‘Except as otherwise provided . . . the gain or loss realized from the conversion of property into cash, or *from the exchange of property for other property differing materially either in kind or in extent*, is treated as income or as loss sustained.’³⁷

In its FAQ, the IRS merely says: “If you exchange virtual currency held as a capital asset for other property, including for goods or for another virtual currency, you will recognize a capital gain or loss.”³⁸ This leads us back to Treas. Reg. § 1.1001-1.

The question, therefore, is twofold. First, whether the token swap/wrapping involves an actual exchange when all the taxpayer is doing is entering the token into a software tool without an actual counterparty (be it a smart contract or an SaaS) and producing a wrapped token or an LST. Second, whether the wrapped token is 'materially different in kind or extent' from the original token.

aa. Exchange of Properties

³⁷ 26 CFR § 1.1001-1(a) (emphasis added).

³⁸ FAQs A16.

There is no statutory definition of what constitutes an exchange for purposes of IRC § 1001(a). According to the Supreme Court, an exchange is a transfer of property for other property.³⁹ In the context of a “sale”, the Tax Court singled out as the key factor “whether the benefits and burdens of ownership have passed” as a question of fact based on the parties’ intention.⁴⁰ The Tax Court has also used different factors, such as (1) whether legal title passed, (2) how parties treat the transaction, (3) whether an equity was acquired in the property, (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.⁴¹

Using the above criteria, neither the act of wrapping nor the receipt of an LST constitutes an exchange because the benefits and burdens of ownership do not pass.

In a reverse order of how the factors are listed above, a liquid staker or taxpayer receives a wrapped token or LST, they continue to maintain the entitlement to current income, inclusive of staking rewards derived from the underlying token or the wrapped token/LST.

The taxpayer bears the risk of loss, whether stemming from protocol failure or theft, given their exclusive engagement with the transaction alongside the smart contract. As such, they assume responsibility for taxes levied on staking rewards and retain the authority to redeem the underlying token at their discretion, whether through unwrapping or cashing in the LST⁴². So, points (6)-(8), above, all suggest that there is no exchange.

Other factors (points (2)-(5)) such as the contractual obligations and equity acquisition can be deemed as less relevant within this context, as the transaction entails the involvement of only a single party alongside the smart contract/ SaaS.

The Proof of Stake Alliance likens Receipt Tokens to warehouse receipts for stored items or a receipt for checking one’s coat at a coat check. It is a cryptographic record substantiating a Liquid Staker’s legal and beneficial ownership of staked cryptoassets, resembling custodial arrangements for physical commodities. These tokens merely serve

³⁹ *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247 (1941) (“exchange . . . implies reciprocal transfers of capital assets”). See also *Duffy v. United States*, 636 F. Appx. 792, 794 (Fed. Cir. 2016) (denying capital gain treatment for a settlement payment in connection with an employment discrimination claim on the grounds that no property was transferred to the employer and thus there was no “exchange”). BNA Tax Portfolio 562-2nd: Capital Assets — Related Issues, I. The Sale or Exchange Requirement, B. Definition of “Sale or Exchange”

⁴⁰ *Grodts & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981).

⁴¹ *Grodts & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981); similar, *Rochlis v. United States*, 146 Fed. Cl. 743 (2020).

⁴² Regarding LSTs, some protocols might require an unbound period.

as a manifestation of the claim on the Liquid Staker's staked cryptoassets, rather than constituting a novel entitlement (point (1)).⁴³

Checking a coat or storing items at a warehouse, evidenced by a receipt is not an exchange under IRC § 1001(a), Treas. Reg. § 1.1001-1. Only if the taxpayer sells the receipt to someone else, entitling the other person to redeem the coat or the stored assets, does an exchange occur.

bb. Materially Different in kind or extent

Even if the wrapping process or the transition to Liquidity Staking Tokens (LSTs) were classified as an exchange due to the introduction of wrapped tokens or LSTs representing a new form of property transfer, the distinction of whether it constitutes an exchange to another materially different property becomes pivotal, albeit increasingly dependent on the specific network and protocol⁴⁴.

The determination heavily relies on the underlying protocol and functionality of the involved tokens within the blockchain ecosystem. Under the Protocol Model of liquid staking, Receipt Tokens are intricately linked to the staked digital assets,⁴⁵ while the Provider Model entails ownership of fungible tokens within a smart contract alongside newly generated tokens from staking.⁴⁶

Wrapping smart contracts adhere to similar mechanics but introduce an additional layer of complexity by altering the functionality, allowing tokens to adopt functions from different blockchains. Thus, the perceived material difference hinges on whether the token's value and technical attributes remain identical across blockchains or if the new blockchain provides distinct technical capabilities and functions. For instance, a token on the Ethereum blockchain might be seen as materially different from its counterpart on the Bitcoin blockchain due to Ethereum's expanded capabilities.

⁴³ Proof of Stake Alliance, U.S. Federal Income Tax Analysis of Liquid Staking, p. 7, 8, available at https://static1.squarespace.com/static/62f147feb8108a08e666aea5/t/63f3fd27f0b0fc45f7d906c2/1676934439845/U.S._Federal_Income_Tax_Analysis_of_Liquid_Staking.pdf, last accessed 2/26/2024 at 4:36pm.

⁴⁴ The format of this Paper does not allow to go into detail for each protocol. Because we argue that Section 1001(a) does not apply due to a lack of exchange, we only offer a rough summary of the potential arguments.

⁴⁵ Proof of Stake Alliance, U.S. Federal Income Tax Analysis of Liquid Staking, p. 10, available at https://static1.squarespace.com/static/62f147feb8108a08e666aea5/t/63f3fd27f0b0fc45f7d906c2/1676934439845/U.S._Federal_Income_Tax_Analysis_of_Liquid_Staking.pdf, last accessed 2/26/2024 at 4:36pm.

⁴⁶ Proof of Stake Alliance, U.S. Federal Income Tax Analysis of Liquid Staking, p. 10, available at https://static1.squarespace.com/static/62f147feb8108a08e666aea5/t/63f3fd27f0b0fc45f7d906c2/1676934439845/U.S._Federal_Income_Tax_Analysis_of_Liquid_Staking.pdf, last accessed 2/26/2024 at 4:36pm.

Drawing parallels from historical legal precedents, such as *Cottage Savings Association v. Commissioner*,⁴⁷ the Supreme Court held that two properties are materially different if they “embody legally distinct entitlements”. Cottage Savings operated a pool of residential mortgages that declined in value. It exchanged that pool for another pool of mortgages and claimed a loss on its tax return. The IRS disallowed the loss on the ground that the two pools of mortgages were not materially different in kind or extent. The Supreme Court that the loss was allowable because the mortgage pools embodied legally distinct entitlements, including that the loans were made to different obligators and secured with different properties.

There are no cases or rulings on wrapping or LSTs. An analogous situation, however, is Rev. Rul. 90-7. There, the taxpayer exchanged certificates in an investment arrangement classified as a trust for a proportionate share of each of the trust's assets, which were bonds. The IRS ruled that the certificate and the portion of an underlying bond to which this Certificate relates to are not materially different to the extent certificates are exchanged for component pieces of the underlying bond in a reconstitution transaction.⁴⁸ Considering that wrapped tokens can be seamlessly unwrapped to their original format, questioning the material difference similar to the certificates and the underlying bonds.

An illustrative method demonstrating the potential lack of material differences for tax purposes between wrapped tokens and their original counterparts lies in the analysis of price development. By examining the market value trends of both types of assets, the correlation between a wrapped token and its underlying token becomes apparent. For example, a comparison conducted using data from CoinGecko.com retrieved on February 28, 2024, around 1 pm, allows for a thorough examination of the price movements of wrapped Bitcoin and Bitcoin over various timeframes, as well as a similar analysis of cbEth and Eth (see attachment). These comparisons provide valuable insights into the synchronization and fluctuations between the wrapped or liquidity tokens and their underlying assets, aiding in a deeper comprehension of their economic interrelationship and potential tax implications. Notably, the analysis reveals that the price movements of wrapped tokens/LSTs closely mirror those of their underlying tokens, suggesting a limited material difference between them. This observation underscores how pegged prices speak against wrapped tokens and original tokens being truly different in kind and extent.

Of course, these two examples do not give a complete picture over all possible variations of wrapped tokens or LSTs. It leads, however, to an additional aspect, the practicality. Analyzing the differences for every combination of blockchains might not be very practical, let alone feasible for normal taxpayers, tax practitioners, and tax administration alike.

⁴⁷ 499 U.S. 554 (1991); 499 U.S. 573, 578, 111 S. Ct. 1512, 1516, 113 L. Ed. 2d 608 (1991).

⁴⁸ Rev. Rul. 90-7, 1990-1 C.B. 153.

Considering that a wrapped token simply represents the original token and can be unwrapped to its original format at any time, the material difference in kind or extent is questionable in the first place.

b. Exchange from LST to Underlying Token

When considering the taxation of staking rewards, it becomes imperative for tax professionals to carefully analyze the process of withdrawing funds from a liquidity staking pool, particularly when converting LSTs back to their underlying assets. This analysis entails a nuanced examination of two distinct components: the principal amount and the staking reward portion of the redeemed asset. The principal amount represents the original sum of the underlying asset initially staked, while the staking reward portion denotes the additional assets earned through staking activities. By discerning and segregating these components, taxpayers can effectively evaluate their tax liabilities associated with the withdrawal process from liquidity staking pools.

Regarding the principal amount, the analysis remains straightforward, as outlined below. Consequently, no taxable event arises concerning this portion. For LSTs, however, the inclusion of the staking reward portion necessitates further consideration.

The staking reward portion within liquidity staking pools takes on different forms depending on the type of Receipt Token involved. In the case of Static Token Receipts, this portion manifests as additional LSTs received upon their generation, resulting in an immediate expansion of the token holdings. Conversely, for Dynamic Token Receipts, the staking reward portion represents an increased value realized upon redemption, reflecting the appreciation accumulated throughout the staking period. These distinctions underscore the critical importance of understanding the specific mechanisms through which staking rewards accrue and are realized, thereby facilitating accurate assessment and compliance with tax obligations. Additionally, for Dynamic Token Receipts, the timing of income recognition becomes a pertinent consideration, raising questions regarding the applicability of constructive receipt principles.

c. No Constructive Receipt for Staking Rewards

After determining whether a taxable event occurred, we need to determine the timing. If the staking rewards are taxed as ordinary income, and rewards accrue over time within the pool, when does the taxpayer recognize the gain, at the time the pool earns the reward and the taxpayer is entitled to his share of said reward, or at the time of withdrawing from the staking pool and exchanging the LST back to his original currency?

Revenue Ruling 2023-14 determined income is recognized at the moment the taxpayer receives dominion and control over the rewarded units of the cryptocurrency. The Revenue Ruling does not specify when a taxpayer gained dominion and control and if the concept of “constructive receipt” applies. Under IRC § 451(a) an item of gross income must be included in gross income for the year in which it is received. Under the constructive receipt doctrine, a cash method taxpayer is deemed to have received an item of income if the item is made available to the taxpayer for immediate receipt, but the taxpayer chooses not to receive it.⁴⁹

Even for taxpayers familiar with the constructive receipt doctrine, conducting a dominion and control analysis for every staking pool is impractical, and aligning it with the IRS's analysis of the same pool is challenging. At a minimum, the IRS should consider guidance on the factors to consider or establishing a red line test how this analysis should be performed.

Opponents might argue that the taxpayers already received a benefit when staking rewards are earned, regardless of whether they are distributed. The mere ability to access and utilize the rewards constitutes an economic benefit, triggering the recognition of income for tax purposes.

But even in a permissionless environment as the crypto ecosystem aims for, until the distribution of rewards from a staking pool occurs, participants do not have full control over the assets held within the pool. This lack of control is particularly evident when considering the potential for slashes, protocol damages, hacks, or other unforeseen events that could occur before rewards are distributed. Despite the automated nature of staking processes, the inherent risks associated with participation in staking pools are significant enough to undermine the concept of dominion and control. Unlike traditional financial instruments where ownership is unequivocal, participation in staking pools involves a degree of trust in the pool operator and the underlying protocol, which may expose participants to unanticipated risks. The adage “not your keys, not your coins” underscores the fundamental concept that control over cryptocurrency assets is contingent upon ownership of the private keys associated with those assets.

Furthermore, the volatile nature of these assets introduces a level of uncertainty regarding their economic value at the time of their accrual. Taxpayers may find it exceedingly difficult to accurately assess the true economic benefit derived from staking rewards amidst such market turbulence. Additionally, the practical ability to monetize or access the full economic value of these rewards is compromised by their susceptibility to significant price fluctuations prior to distribution. This volatility undermines the traditional

⁴⁹ Treas. Reg. §§ 1.451-2(a), 1.451-1(a), 1.446-1(c)(1)(i).

concept of dominion and control, as taxpayers may not possess practical control over the rewards' value until they are effectively received.

This issue could be automatically resolved if, legislatively, the inclusion of staking rewards as income were deferred to the moment of sale — the point at which the taxpayer monetarily benefits from the staking activity. Aside from legislative action, constructive receipt can lead to economically unjust since, due to the volatility of cryptocurrencies, the monetary benefit can significantly differ from the fair market value at the time of receipt. The Lummis-Gillibrand Responsible Financial Innovation Act 2023 offers a solution to income deferral, by deferring recognition of income from staking and mining activities until the sale or other disposition of the assets received from such activity.⁵⁰

D. Problems Addressed

We propose additional guidance to address the problems discussed above.

1. **Issuing additional guidance stating that the swap of tokens to liquidity staking tokens through smart contracts or SaaS provider in direct connection to staking the underlying token is not a taxable event.**

Qualifying this as a non-taxable event simplifies the calculation of taxable gain and avoids the complexity of analyzing whether freezing a token on a certain blockchain to receive a wrapped token on another blockchain constitutes the exchange of property for other property differing materially either in kind or in extent.

2. **Issuing additional guidance to clarify Revenue Ruling 2023-14 that the requirement of dominion and control excludes the application of the constructive receipt doctrine as described under Treas. Reg. § 1.451-2, to determine the moment of receipt of staking rewards.**

This paper proposes that the IRS not consider constructive receipt and issue guidance that a taxpayer only has to recognize staking rewards once they are received by a wallet under his control. Thus, the mere receipt of a staking reward by a staking pool does not trigger income inclusion for the taxpayer who is eligible but has not yet received a distribution of such a reward. This proposal aims to avoid complex analyses and, consequently, corresponding litigation on the question of when a staking pool grants sufficient control or access to the

⁵⁰ See changes to IRC § 451 of the Internal Revenue Code proposed in Sec. 808 of the Lummis-Gillibrand Responsible Financial Innovation Act 2023, see <https://www.lummis.senate.gov/wp-content/uploads/Lummis-Gillibrand-2023.pdf> p. 244, last accessed on 12/27/2023 at 3:44pm (PST).

tokens to trigger constructive receipt for the taxpayer designating tokens to the pool. It ensures a uniform treatment among the same staking mechanism, such as staking pools.

3. **Issuing additional guidance stating that wrapping and unwrapping of tokens is not a taxable event.**

This paper proposes that the IRS issue guidance that wrapping/ unwrapping is not a taxable event. This would simplify the calculation of taxable gain and avoids the complexity of analyzing whether freezing a token on a certain blockchain to receive a wrapped token on another blockchain constitutes the exchange of property for other property differing materially either in kind or in extent.

E. Merits of Proposal

The proposed changes simplify and standardize the tax treatment of digital asset transactions that would otherwise require a complex technical analysis and comparison with the underlying protocol. This provides additional certainty for the taxpayer and removes obstacles to becoming or remaining tax compliant. The proposed changes avoid lengthy case-by-case determinations and analytical examination and interpretation of protocol source codes. .

F. Feasibility

IRC § 7805 provides the Secretary of the Treasury the authority to provide rules and regulations to enforce the Code. The issuance of guidance whether in the form of regulations or otherwise is politically and economically feasible as it provides clearer standards to determine the taxable income relating to digital assets.

G. Tax Official Contacts

The author has not discussed this proposal with any tax officials in Washington.

H. Statement

The authors of this paper may have clients affected by the rules and regulations applicable to the subject matter of the proposed paper, but the authors have not been engaged by any a client to participate in this paper.