Something to Prove on Proof of Stake: Plaintiffs in Jarrett Reject IRS Refund on Taxed Tokens

A recent IRS concession bodes well for how the tax treatment of proof of stake validators may develop through case law. On December 20, 2021, the IRS offered a full refund to the plaintiffs in Jarrett et al v. United States for taxes paid on tokens created through proof of stake on the Tezos blockchain in 2019. In a statement released February 3, 2022, Joshua Jarrett confirmed the decision to seek an IRS ruling in the cryptocurrency case, rather than accept the tax refund. "I need a better answer," Mr. Jarrett states.

In rejecting the offer, the plaintiffs explained that the IRS has given no assurances on the tax treatment of crypto staking rewards in presenting the refund. To protect against future challenges on taxability, the Jarretts intend to vindicate their rights in a definitive ruling on the key issue—whether tokens created through staking represent taxable income at the time of creation.

Creation of New Property through Proof of Stake

Blockchain systems rely on consensus mechanisms, also referred to as consensus protocols or consensus algorithms, to operate and remain secure. Proof of stake is an increasingly popular blockchain consensus mechanism, given its advantages over the significant energy demands and hardware requirements of proof of work. Because the barriers to entry are lower, proof of stake encourages broader participation, more nodes in the network, and stronger immunity to centralization. While currently operating under proof of work, Ethereum has announced a full transition to proof of stake in this year's upgrades. Other popular blockchains have long incorporated the proof of stake consensus method, including Tezos.

As one of the most decentralized protocols, Tezos features a self-governance model that allows for upgrades without the disruption of hard forks, in which the blockchain diverges based on different rule sets. In 2017, Mr. Jarrett originally became involved with Tezos in light of its innovative system and the ability to participate without a formal computer science background, costly hardware, or high energy consumption. Through proof of stake, he validated transactions and created new blocks to keep the Tezos blockchain decentralized and secure, receiving newly created tokens.
tokens as rewards.

**Not Yet Realized**

Joshua and Jessica Jarrett originally reported the receipt of Tezos tokens from staking as income on their 2019 tax return. They later filed an amended return to request a refund for taxes paid on the Tezos token rewards and received no response from the IRS.

In a complaint filed May 26, 2021 in the Central District of Tennessee, the Jarretts petitioned for the refund of federal income taxes on the Tezos tokens created via the proof of stake protocol. Citing well-established principles of income realization, the plaintiffs contend there should be no income event for tax purposes when tokens are first created through a staking enterprise. As taxpayer-created property, the Jarretts argue, the token rewards are not subject to tax unless and until such property is sold or exchanged, on the grounds that the property is not yet "realized" wealth. The complaint draws the comparison to other creative activities, observing that the landmark Supreme Court case *Commissioner v. Glenshaw Glass Co.* "would not tax the baker solely because he bakes a cake, or the writer solely because she writes a book."

In offering the refund, the IRS signaled that it no longer wished to defend its position with respect to the plaintiffs’ 2019 taxes on the staking rewards. In their decision to pursue a ruling instead, the plaintiffs in *Jarrett* may set a far-reaching precedent for taxpayers engaging in cryptocurrency mining or staking activities.

For questions about blockchain and related cryptocurrency tax issues, please contact Nancy Dollar or the Hanson Bridgett Tax Group.

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