

Taxpayers in Jarrett Case Still Seek an Answer on Crypto Staking

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A court decision on a lawsuit over the taxation of cryptocurrency staking rewards would provide taxpayers some much-needed guidance in this area, says Hanson Bridgett LLP's Nancy Dollar. Without a definitive ruling on the case, it could remain largely unsettled how tokens created through staking activities are taxed.

A lawsuit over the taxation of cryptocurrency staking rewards is still alive in spite of an uncashed IRS refund check sitting a drawer, according to the plaintiffs' recent court filing. After responding to the government's motion to dismiss, the taxpayers in *Jarrett v. United States* filed a motion on March 28 to amend their original complaint and further clarify they are seeking injunctive and declaratory relief. The taxpayers maintain they are entitled to a judicial resolution and protection against future challenges on the discrete and recurring question of the lawsuit—whether tokens created through staking represent taxable income at the time of creation.

Identifying gaps in U.S. tax policy specific to crypto staking rewards, a bipartisan group of Congress members has urged the IRS to provide clearer rules for taxpayers. Given the general lack of IRS guidance on cryptocurrency paired with increased enforcement efforts, a decision on the *Jarrett* case would provide taxpayers some much-needed guidance in this area. However, the government has signaled it is not interested in setting precedent through the refund suit. Without a definitive ruling on the case, it could remain largely unsettled how tokens created through staking activities are taxed.

Newly Created Reward Tokens Through Proof of Stake

Generally, a blockchain is a distributed and decentralized public database that exists across a network. Because the database relies on multiple participants and computer nodes, there must be agreement on the network's current state. Consensus mechanisms, also referred to as consensus protocols or consensus algorithms, establish agreement for blockchain systems to operate and remain secure. For a transaction to be recognized, validators must append it to the blockchain through the consensus mechanism. In most protocols, crypto rewards in the blockchain's native token incentivize validators to maintain the network. These are commonly referred to as block rewards or reward tokens.

An increasingly popular class of blockchain consensus mechanisms is known as "proof of stake." Under proof of stake, each new block of data is appended to the chain using an algorithm to select a node to broadcast its block to other nodes for verification. The likelihood of selection increases based on the quantity of holdings in the associated tokens, which guards against attacks on the blockchain's integrity or other malicious behavior. As blocks are verified via staking, the validators often acquire reward tokens created in the course of the process as rewards.

The Tezos network is among the blockchains that incorporates a proof of stake consensus mechanism. Token holders maintain the Tezos blockchain through staking, which results in newly created tokens added to their existing holdings. Tokens earned through staking on the Tezos network increases the total number of Tezos tokens in existence, diluting the market value of the tokens.

Claim of Refund on Taxed Reward Tokens

In 2019, Joshua Jarrett validated transactions on the Tezos blockchain by staking his tokens, acquiring 8,876 newly created tokens as rewards. On the income tax return filed for that year, the Jarretts originally reported the creation of reward tokens as "other income" under line 8 of Schedule C. In July 2020, the couple filed an amended return for a tax refund on the position that the reward tokens created did not represent taxable income. The Jarretts received no response from the IRS on the refund claim.

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 argued there should be no income event for tax purposes when tokens are first created through staking.

On Dec. 20, 2021, the government authorized a full tax refund on the Jarretts' claim. In a letter dated Jan. 25, 2022, the Jarretts rejected the refund offer, as the IRS had given no assurances on the future treatment of crypto staking rewards. The refund check for an overpayment of \$3,793, plus statutory interest, was delivered to the Jarretts' counsel on Feb. 14.

On the grounds that the action for a refund claim is now moot, the government then moved to dismiss the case. The plaintiffs contend the unaccepted settlement offer does not render their case moot, pointing to the Supreme Court’s holding in *Campbell-Ewald Co. v. Gomez* as favorable case law in their brief filed March 14. The crypto lobbying group Coin Center filed an amicus curiae brief, emphasizing the “immense public importance” of addressing the question presented in the case. The government has denied that the class action lawsuit in *Campbell-Ewald Co.* is on point for the refund case and objected to the Coin Center amicus brief. To protect against a facial challenge raised in the government’s reply, the Jarretts requested to amend their complaint to specifically plead for injunctive and forward-looking relief.

Realization of Crypto Staking Rewards

The key issue in *Jarrett* is whether creating tokens from proof of stake constitutes taxable income to the validator. The plaintiffs cite the fundamental premise that taxpayer-created property is not income. Income derived from an investment of the taxpayer’s own labor and capital to create new property is not actually the property itself, but rather the gain realized on the property’s disposition. As a result, the Jarretts argue, the token rewards are not subject to tax unless and until such property is sold or exchanged, triggering a realization event. In their complaint, the taxpayers drew the comparison to other creative activities, stating that the modern standard for gross income under the 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.”

From a practical standpoint, taxing token rewards may be even more inequitable than taxing other taxpayer-created property. Unlike a painting taxed as income on the day the painter sets down the brush, for instance, or a fish taxed as soon as it is caught in a net, tokens created through proof of stake carry an inflationary effect because they increase the overall supply in the network. Akin to a stock split or pro rata stock dividend, universal participation in Tezos staking and generation of proportionate rewards results in zero economic gain for any particular holder. At a less than 100% participation rate, any single token holder’s “return” on staking would still be subject to significant lost market value due to dilution. Therefore, taxing reward tokens on a one-to-one basis, as earned, appears to grossly overstate the taxpayer’s actual economic gain.

Closing *Jarrett* with a refund provides no certainty on the future tax treatment of staking activities or insight on the current IRS position. Absent a definitive ruling, taxpayers may need to wait for further guidance on the proper timing and inclusion of reward tokens in taxable income.

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