When Are My Rewards for Staking Cryptocurrency Taxed?

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If a taxpayer uses the cash receipts and disbursements method of accounting (cash-method), rewards received for staking cryptocurrency will be taxable. (Individuals and many small businesses use the cash-method of accounting.) The amount includible in income will be the fair market value of the reward in the taxable year in which the taxpayer has "dominion and control" over the reward; that is, the taxable year in which the taxpayer has the ability to sell, exchange, or otherwise dispose of the reward.

Analysis

The IRS recently released Revenue Ruling 2023-14, in which it addresses the tax treatment of cryptocurrency staking rewards. The IRS phases the issue as follows: If a taxpayer that uses a cash method of accounting (cash-method taxpayer) stakes cryptocurrency native to a proof-of-stake blockchain and receives additional units of cryptocurrency as rewards when validation occurs (validation rewards or rewards), must the taxpayer include the value of the rewards in the taxpayer's gross income and, if so, in which taxable year?"

Cryptocurrency staking is when an owner of cryptocurrency pledges all or part of its cryptocurrency toward helping validate transactions on the blockchain. Only certain types of cryptocurrency allow staking (*e.g.*, Ethereum, Tezos, Cosmos, Solana, Cardano, but not Bitcoin), and they each have their own protocols for staking. The incentive for staking is earning validation rewards. Validation rewards typically consist of one or more newly created units of the cryptocurrency native to a specific blockchain.

In determining the tax treatment of validation rewards, three dates are relevant.

- **Date 1.** The date the taxpayer stakes the cryptocurrency. On this date, the taxpayer generally lacks the ability to sell, exchange, or otherwise dispose of any units (*i.e.*, validation rewards) received as the incentive for staking.
- **Date 2.** This usually follows shortly after Date 1 and is the date that the taxpayer has the ability to sell, exchange, or otherwise dispose of the validation rewards (*i.e.*, the taxpayer has dominion and control over the validation rewards).
- **Date 3.** The date the taxpayer sells, exchanges, or otherwise disposes of the validation rewards.

The revenue ruling answers three questions. First, it makes clear that taxpayers are taxed on the receipt of validation rewards. Second, it determines the taxable year in which the income from the validation rewards must be included. Finally, it determines the amount of the validation rewards that is included in income and, thereby, subject to tax.

In Which Year Is the Income from a Validation Reward Included?

The revenue ruling holds that, in the case of a cash-method taxpayer, the fair market value of the validation rewards received is included in the taxpayer's gross income in the taxable year in which the taxpayer gains dominion and control over the validation rewards; that is, when the taxpayer has the ability to sell, exchange, or otherwise dispose of the cryptocurrency. (This is Date 2 above.) Thus, even though the taxpayer has not sold, exchanged, or otherwise disposed of the validation rewards, the validation rewards must nevertheless be included in income in the taxable year when the taxpayer has the ability to do so.

The taxpayer's tax basis in the validation rewards for later transfer purposes will be the fair market value of the validation rewards determined as of Date 2 (*i.e.*, the amount includible in the taxpayer's gross income). Because cryptocurrency is treated as property for tax purposes, the taxpayer will recognize gain or loss upon a later sale, exchange, or other disposition of the validation rewards/units. Thus, the use of the validation reward to purchase a good or service will result in gain or loss. In contrast, had the taxpayer received a cash reward, the use of the cash to purchase a good or service would not result in gain or loss.

When Is the Fair Market Value of the Validation Rewards Determined?

The value of cryptocurrency is constantly changing, not just daily but throughout the day. Thus, the revenue ruling holds that the fair market value of the validation rewards is determined "as of the date and time" (the day and time of day) the taxpayer gains dominion and control over the validation rewards. It does not look to an average of the fair market value for the day. This is the case whether the taxpayer stakes cryptocurrency directly or through a cryptocurrency exchange.

There was little doubt before the revenue ruling that the receipt of validation rewards is taxable. The significance of the revenue ruling is that it clarifies the taxable year in which the fair market value of the validation rewards is included in income and the time at which the fair market value is determined. Some taxpayers have contended that the validation rewards are not included in income until their sale, exchange, or other disposition.

The revenue ruling makes clear that it does not address issues that may arise under any rules not specifically cited, including Section 83 of the Internal Revenue Code of 1986.

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