



Talking Asset Management with KPMG

Staking

Below is a transcript of *Talking Asset Management with KPMG*. In this episode, **Anthony Tuths**, Digital Asset practice leader, is joined by **Peter Ritter**, Washington National Tax Principal focused on Financial Institutions and Products, and **Josh Tompkins**, Washington National Tax Managing Director focused on Financial Institutions and Products, to discuss staking, from general tax considerations to potential implications for various classes of investors, such as foreign and tax-exempt investors.

Anthony Tuths:

Hello and welcome. I'm Tony Tuths, leader of the KPMG Digital Asset practice. I'm joined today by Pete Ritter and Josh Tompkins from the KPMG Washington National Tax Group. We're going to spend some time today talking about a very hot topic in the cryptocurrency industry, and that is staking. So, before digging into the particulars of staking, Pete, perhaps you can give us a high-level overview of how cryptocurrencies work generally.

Peter Ritter:

Sure, Tony. Thanks much. Yes, to understand staking, you need to have a basic understanding of how cryptocurrencies work generally. And crypto transactions, they function on blockchains, which are decentralized in the sense they use a so-called peer-to-peer model, and with this model, there's no need for a centralized entity or person to validate a given transaction or keep track of cryptocurrency ownership, instead all of that work is done by computers or nodes on the network, using what's sometimes referred to as a consensus mechanism, and that's basically an algorithm that allows all the computers to agree or form a consensus on a proposed transaction or current ownership without the need for a neutral referee.

The way it works is as follows. A given transaction is first broadcast to the network and then it's verified or validated using cryptography, and that's encryption and decryption

through a so-called mining or staking consensus process. And once confirmed, each transaction is then recorded with other transactions in a quote unquote block of computer code that is then added and linked to previous blocks to form a chain. That's why you hear 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.

Anthony Tuths:

Great. So, mining and staking seem to be the two main consensus mechanisms currently utilized. Josh, can you tell us more about mining and staking?

Josh Tompkins:

So, like you said, Tony, mining and staking are the two methods used to validate a transaction on a blockchain network. Mining, which is done on a proof-of-work blockchain, is the original validation process, and people generally associate it with Bitcoin. Essentially, in a proof of work mining system, the first miner to solve the cryptographic puzzle to validate a transaction is rewarded with newly minted or created cryptocurrency, and in some cases, also receive a share of transaction fees.

Staking, which is done on a proof-of-stake blockchain, is what we are focused on today, and at a very high level, under a proof-of-stake consensus mechanism, validators

contribute or lock up or stake their own crypto in exchange for a chance of getting the opportunity to validate a new transaction, update the blockchain, and earn a staking reward. Staking rewards generally consist of newly created cryptocurrency, but in some cases, they might also include transaction fees paid by users.

In terms of how taxpayers or market participants do this, there are a few different ways. So you can stake directly by running a node, but you can also employ another party to stake on your behalf through a noncustodial staking arrangement. In that type of arrangement, cryptocurrency is delegated to another validator in exchange for a portion of the staking rewards.

Other options include custodial staking, where a custodial market participant actually takes possession of the cryptocurrency and shares a portion of the rewards. Then there's also liquid staking, where a taxpayer exchanges their cryptocurrency for a tokenized version of the staked asset.

Anthony Tuths:

So, now with that background, Josh, what are the tax consequences for those that engage in staking?

Josh Tompkins:

Well, there are quite a few things to think about, and like most things in crypto, the answers aren't entirely clear. For example, to stake on the Ethereum Blockchain you must first convert Eth to Eth 2.0, which raises an initial question of whether or not that conversion could be taxable. On that point, taxpayers may find comfort in the IRS FAQs, which state that a soft fork or a fork that does not result in a split in the blockchain is not a taxable event. So in other words, because taxpayers are converting Eth to Eth 2.0, we'll only have one currency before and after the conversion, the FAQs would seem to indicate that that it's not a taxable transaction.

Other important considerations include the time at which staking rewards should be included in taxable income and also the character of such income. As the timing, the IRS is of the view that a proof of work mining reward constitutes gross income equal to its fair market value when received. This position was set forth in a 2014 IRS notice. For staking, there is no official IRS guidance. But many take the view that staking rewards should be treated in a similar manner to mining rewards, and therefore ought to be gross income when received.

There is, however, an alternative theory. Recall that staking rewards generally consist of newly created cryptocurrency. Under this alternative theory, commonly referred to as the self-created property characterization, staking rewards are treated as being created by the staker and are therefore not subject to tax until sold. The idea here is that simply creating property is a nontaxable event. For example, a farmer isn't taxed on their growing crop; rather, the taxable

event occurs only later, when the crop is sold. The same for a musician, artist, or writer—they are not taxed when the recording is finished, a piece of art is created, or a manuscript is written. Only later, when those properties are sold, is tax accessed. Obviously, the relevance of this theory depends to some extent on the characteristics of the blockchain in question and whether or not the reward system relies on newly created property, but it is a theory that is out there.

It has received quite a bit of press recently on account of a case being litigated in Tennessee district court. The taxpayers in that case, the Jarretts, sought a refund of roughly \$4,000 in connection with taxes paid on staking rewards, and their argument for the refund request was essentially the self-created property theory. The IRS ultimately did grant the refund, but it didn't provide any rationale or analysis or indication that it agreed with the taxpayer's position. So, the answer here remains unclear.

In addition to timing, the other basic consideration is character. In that respect, the answer depends to some extent on which of the two theories I've described is adopted. So, with the immunity income theory, the receipt of a staking reward would give rise to ordinary income equal to the value of the cryptocurrency received. For many taxpayers, the later sale of the staking reward would likely produce capital gain or loss. That is even if the staking reward is ordinary income when received. In many cases, the later sale would involve the sale of a capital asset, especially if one looks at section 1221 of the code, which defines capital asset.

Under the self-created property characterization, perhaps the entire staking reward would be characterized as capital gain, because there isn't any accession of taxes until the reward is sold. Timing and character are really just the tip of the iceberg though. There are a host of other issues, including whether a taxpayer is engaged in a trade or business, whether delegated staking creates a deemed partnership, and whether the exchange of cryptocurrency for a liquid staking token is taxable. And that's just to name a few.

The analysis of these issues is often fact specific, and different taxpayers could certainly have different treatments, depending on the scale of their activities, the blockchain they're staking on, how they're staking, and whether staking is undertaken with a view toward long-term appreciation or an immediate sale of the staking rewards.

Anthony Tuths:

Thanks, Josh. So, there's definitely a lot to consider there. So having talked about some of the general tax considerations around staking, Pete, maybe you could describe some of the tax considerations that might exist for special classes of investors, such as foreign and tax-exempt investors.

Peter Ritter:

Sure, Tony. Yes, this is where things get interesting here as well. For foreign investors, there are essentially two goals here. The first is to not be engaged in a U.S. trade or business, so as to avoid full-blown net income tax in the U.S. and the corresponding tax return filing obligation. And the second is to not be subject to the 30 percent withholding tax that's imposed in the U.S. on certain types of U.S. source passive income, which is sometimes referred to as Fixed, Determinable, Annual, or Periodical (FDAP). So, there are basically two issues here with staking. That is, can staking result in a U.S. trade or business, and if not, are the staking rewards a U.S. source FDAP and subject to 30 percent withholding.

As to the U.S. trade or business issue, if one is self-staking, as we described, it seems as if there's a real risk, especially if the staking activities are taking place here in the United States. And in particular, it seems as if staking is the performance of some kind of service, which if performed in the United States, certainly seems to give rise to a U.S. trade or business, one would think.

With respect to delegated staking, however, there is a position out there that there is no U.S. trade or business, and many in the market seem to be taking this non-U.S. trade or business position. It's certainly not without risk, but there is that position. And if one gets past this U.S. trade or business point, then there is the FDAP withholding issue to consider.

And it does seem as if staking rewards are FDAP of some kind. But sourcing these rewards isn't easy to do, and again, is the validation activity a service? And if so, should one therefore look to see where the staking activity is taking place, and if that's right, how do you even do that here? And if one believes in the self-created property theory that Josh had mentioned previously, perhaps sourcing is based solely on the later sale of the reward.

It's worth mentioning there is a Treasury regulation out there that basically says that if sourcing cannot be determined at the time of payment, then it's presumed to be U.S. sourced, and this presumption could be a real

problem or issue here in the crypto staking scenario. And given this ambiguity, many, especially in the delegated staking context, are trying to set things up so that all staking activity, meaning the computers, nodes, personnel, et cetera, is clearly being performed outside of the United States so as to be foreign sourced, and therefore not subject to this 30 percent FDAP holding.

To U.S. tax exempts, there is the unrelated business taxable income or UBTI issue to deal with, and U.S. tax exempts, although they're generally exempt from tax, they are subject to tax on their UBTI. And here, if a U.S. tax exempt is self-staking, it certainly seems as if the staking rewards are UBTI.

Well, what about rewards in a delegated staking context? And here, the code, the internal revenue code exempts certain investment income from UBTI—in particular, there is a code provision, section 512B, that exempts gains from the sale of property, dividends, interest, rents and royalties. The idea here is that certain passive-type investment returns earned by U.S. tax exempts are not subject to tax. With delegated staking, it does seem as if the staking rewards are somewhat passive, in that the U.S. tax exempt is no longer performing any type of validation service. That activity is now being done by someone else.

That being said, the staking rewards here do not neatly fit with any of the section 512B exceptions, and therefore, it does seem as if it's risky to rely on section 512B to avoid UBTI. The bottom line is that there is significant UBTI risk with staking rewards earned by U.S. tax exempts.

Anthony Tuths:

Thanks, Pete. So there's definitely a lot of tax issues to consider before engaging in staking activities. I want to thank both of you for your time and expertise today. Also, for our listeners who want to know more about the tax issues surrounding staking, Pete and Josh have an article on the subject of staking in the latest edition of the *Journal of Taxation of Financial Products*. If you don't have access to this journal, please reach out to one of us, and we can get a copy to you. From all of us at the KPMG Digital Asset practice, thank you for listening.

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