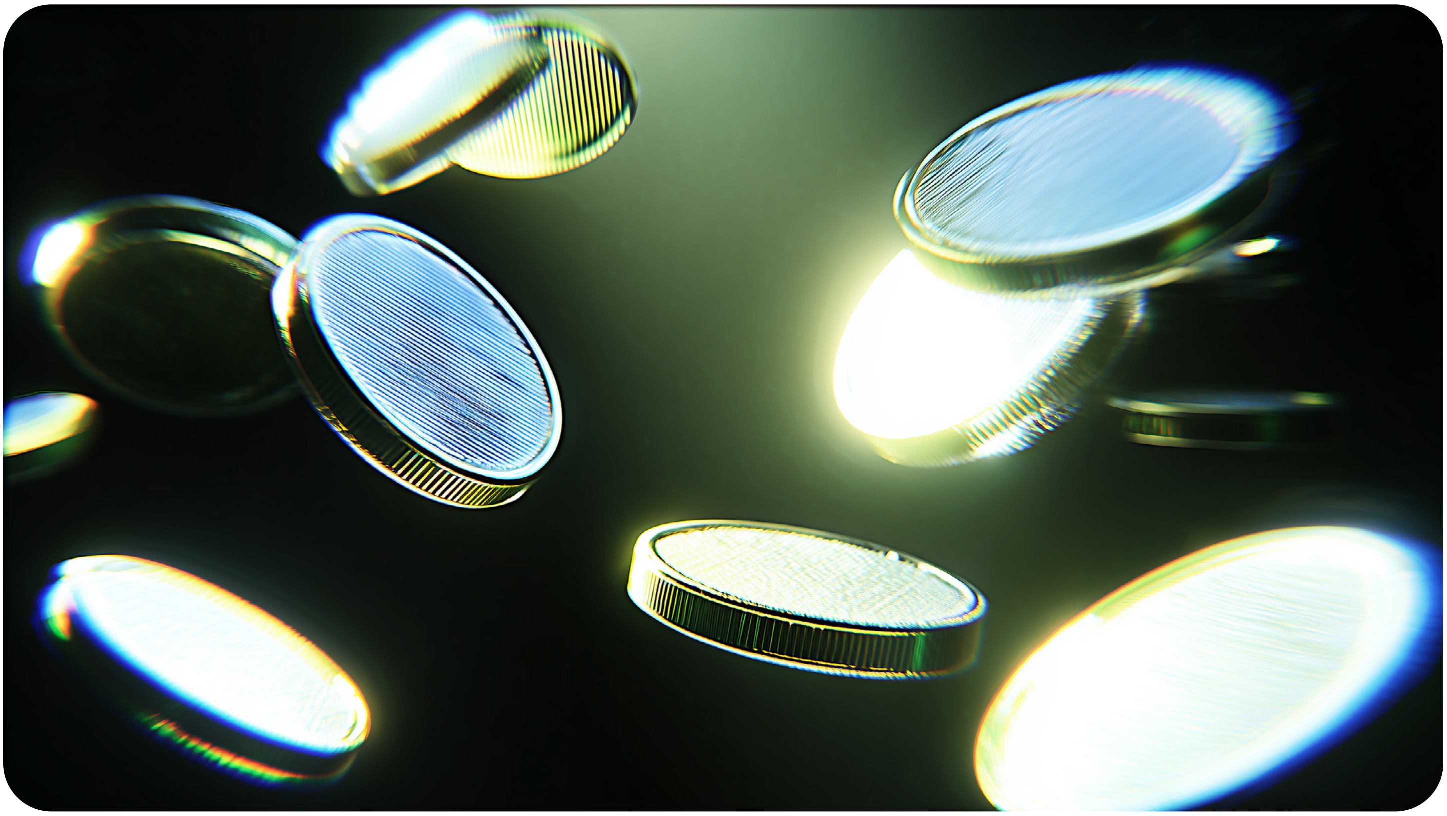

Taxation of Staking Rewards

Policy Playbook

Ava Labs.

Owl Explains

Owl Explains, in conjunction with law firms Cahill and Fenwick, is pleased to distribute this playbook setting forth the authors' preferred approach to legislative and interpretive guidance on the taxation of staking rewards to ensure that the methodology employed by Congress and/or Treasury is as consistent as possible with existing tax law.

The timing is right for this document because various members of the Senate and the House of Representatives, including Senator Lummis and Representative Ferguson, are focused on relevant legislation covering several issues related to taxation and digital assets. Clarity around the taxation of staking rewards has been an issue for those operating validator nodes and delegating stake ("staking") since the rise of proof of stake as the basis for consensus mechanisms, as demonstrated most vividly by the *Jarrett v. United States* litigation, in which the IRS refunded Mr. Jarrett for the full amount of taxes he paid on his new tokens created via staking. *See Jarrett v. United States*, 2022 WL 4793235 at *1 (M.D. Tenn. Sept. 30, 2022).

The following is our suggested three-step approach to (i) clarifying tax rules in order to ensure that staking rewards comprising newly created tokens are taxable not at the time of creation, but rather, consistent with over a century of tax law, at the time they are first sold or exchanged in a taxable transaction (a "disposition"), and (ii) applying the same treatment to transaction fees and MEV to achieve an administrable approach to the taxation of all staking rewards. For an explanation of the legal analysis relating to staking rewards comprising newly created tokens, please refer to Annex 1.

The steps described below are designed to work in conjunction with each other, but the implementation of any step would be an improvement to the status quo and would help to clarify the proper tax treatment of staking. For example, even stopping after Step 1 would be very helpful.

STEP 1

Clarification of IRS Guidance on Staking

a. The Treasury Department and the IRS would issue a new revenue ruling that clarifies its previous guidance on the taxation of staking rewards set forth in Rev. Rul. 2023-14, to eliminate any confusion about the application of longstanding tax law.

b. The new revenue ruling would:
   i. Clarify that Rev. Rul. 2023-14, in accordance with its own language, applies only when tokens are "received" from someone else and not to newly created tokens.
   ii. Confirm that rewards from staking that are newly created tokens are not income on creation but rather on disposition.
   iii. Modify Notice 2014-21 to remove questions 8 and 9 to the extent they state or imply that tokens created though mining are taxable solely as a result of their creation

c. These simple changes, which are consistent with longstanding tax law, would correct any misunderstandings about current law and also could have a positive impact on scoring any complementary legislation; we understand that the Joint Committee on Taxation's current scoring methodology for staking-related tax legislation is currently based on the incorrect presumption that new tokens created through staking and mining give rise to income at the time of creation rather than on disposition.

STEP 2

Proposed Legislation

a. Congress would pass legislation confirming that new tokens created through staking and mining do not give rise to income at the time of creation but rather at the time of disposition. In the interest of tax administrability and the tax law's general preference of taxing income streams according to their predominant character instead of disaggregating them, the legislation ideally would treat transaction fees and MEV rewards the same way it treats newly created tokens.

b. Location of the new language in the Internal Revenue Code
   i. We would prefer the text of any legislation on staking rewards to not be included in Section 451 or any of the accounting provisions of the Internal Revenue Code. This is because such placement could create an inference, contrary to existing law, that but for an act of Congress, new tokens created through staking and mining are taxable at the time of creation rather than disposition.
   ii. Rather, we would prefer that Congress include a new section in Subchapter B that would serve as a confirmation that new tokens created through staking and mining do not constitute income until disposition.

c. Proposed Text
   i. Exhibit A below contains our proposed language, which is based on draft legislation circulated by Rep. Ferguson in the prior Congress. Note that it creates a new section in Subchapter B and could not be read as inferring that, but for an act of Congress and contrary to longstanding tax law, new tokens are taxable at the time of creation. For more explanation on the potential for an incorrect inference, see Step 3 Legislative History, below.
   ii. If Sen. Lummis' recent draft language is preferred, we suggest some textual edits that would ameliorate a potential incorrect inference about the application of longstanding tax law, as shown in Exhibit B.
   iii. If such an incorrect inference could result from

the legislation that is ultimately passed, either by including the new section in the accounting provisions or otherwise, it is particularly important to include clarifying legislative history as discussed in Step 3 below.

iv. We think that existing principles of tax law regarding the character of income as capital or ordinary are readily applicable to income associated with rewards from staking and mining, so no special legislation regarding character is necessary or desirable.

v. We wholeheartedly endorse the language in recent draft bills that all staking rewards, including transaction fees and MEV rewards, regardless of whether such rewards are created or received, are taxable only upon disposition of the tokens. As mentioned above, that approach eases tax administrability and is consistent with the tax law's general preference of taxing income streams according to their predominant character instead of disaggregating them.

d. Definition of Staking

i. The definition of staking should be included in legislation regardless of which language (Exhibit A or Exhibit B) is chosen and ought to be broad enough to include market standard terms and concepts, including, without limitation, operation of a validator node, MEV providers, and operation of liquid staking pools, as well as future innovations relating to the validation of blockchain transactions.

ii. Broad references to a "blockchain consensus mechanism," the term used in some drafts, is ambiguous as it might be both under-inclusive and over-inclusive with respect to the nature of staking (and mining). Accordingly, we refer generally to staking and mining in our suggested language in Exhibits A and B.

e. U.S. Trade or Business

i. The new legislation amends section 864(b)(2) to confirm that the mere trading of digital assets and staking do not give rise to a U.S. trade or business.

STEP 3

Legislative History

a. We would strongly encourage one or more tax writing committees of Congress to include a statement that the drafted language is not intended to create any kind of incorrect inference whatsoever as to the treatment of new tokens created through staking and mining prior to enactment. See Exhibit C for a draft statement to be included in the committee report.

b. This would go hand in hand with our proposal to clarify and modify existing IRS guidance on the treatment of staking.

Exhibit A – Preferred Language

DIGITAL ASSET MINING AND STAKING.

(a) IN GENERAL. — Part II of subchapter B of chapter 1 of the Internal Revenue Code is amended by adding at the end the following new section:

"SEC. 92. DIGITAL ASSET REWARDS.

(a) IN GENERAL. — If, pursuant to staking or mining with respect to any digital asset (including, for purposes of this subtitle, the operation of a validator, directly or through an agent, and any activities closely related thereto), a person acquires (directly, or indirectly through a service provider) a reward of a digital asset—

(1) no income or gain shall result at the time of such acquisition, and

(2) on the disposition of such digital asset in any taxable year, the income or gain (if any) with respect to such asset shall be the income or gain, as the case may be, from the disposition for such taxable year.

(b) DEFINITIONS. — For purposes of this section —

(1) DIGITAL ASSET. —The term 'digital asset' shall have the meaning given such term under section 6045(g)(3)(D).

(2) For purposes of this subtitle, mining and staking include all activities and commitments of resources directly or indirectly resulting in the validation of transactions on a blockchain, including the operation of validator nodes, and any activities and commitments of resources related thereto.".

(b) Source of Income Related to Consideration Received.

(1) Section 863 of the Internal Revenue Code of 1986 is amended by adding at the end the following new subsection:

"(f) Source of Income Related to Consideration Received. — The source of any income related to digital asset mining or staking shall be determined by reference to the residence of the recipient as determined under section 988(a)(3)(B).".

(2) Paragraph (2) of section 864(b) of the Internal Revenue Code of 1986 is amended by redesignating subparagraph (C) as subparagraph (D) and by inserting after subparagraph (B) the following new subparagraph:

(B) the following new subparagraph:

"(C) DIGITAL ASSETS.

(i) IN GENERAL. — Trading in digital assets through a resident broker, commission agent, custodian, digital asset exchange, or other independent agent.

(ii) TRADING FOR TAXPAYER'S OWN ACCOUNT. — Trading in digital assets for the taxpayer's own account, whether by the taxpayer or the taxpayer's employees or through a resident broker, commission agent, custodian, digital asset exchange, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. This clause shall not apply in the case of a dealer in digital assets.

(iii) DEFINITIONS. — For purposes of this subparagraph, the term 'digital asset exchange' means a centralized or decentralized platform which facilitates the transfer of digital assets (as defined in section 6045), and the term 'trading in digital assets' includes mining and staking, as such terms are used in section 92(b)(2).

(iv) (iv) LIMITATION. — This subparagraph shall apply only if the digital assets are of a kind customarily dealt in on a digital asset exchange and if the transaction is of a kind customarily consummated at such exchange.".

(c) Clerical Amendment. The table of sections for part II of subchapter B of chapter 1 of such Code is amended by adding at the end the following new item:

"Sec. 92. Digital asset rewards.".

(d) Conforming Amendment. Subparagraph (D) of section 864(b)(2) of the Internal Revenue Code of 1986, as redesignated by subsection (b)(2), is amended by striking "(A)(i) and (B)(i)" and inserting "(A)(i), (B)(i), and (C)(i)".

(e) Effective Date. — The amendment made by this section shall apply to taxable years beginning after the date of enactment of this Act.

Exhibit B – Alternative Language

DIGITAL ASSET MINING AND STAKING.

(a) In General.-Section 451 of the Internal Revenue Code of 1986 is amended by adding at the end the following new subsection:

"(l) Income Recognition for Digital Asset Activities. — In the case of a taxpayer who conducts digital asset mining or staking, any income relating to such mining or staking shall be included in the gross income of the taxpayer in taxable year of the sale or other disposition of the assets produced or received in connection with the mining or staking. For purposes of this subtitle, mining and staking include all activities and commitments of resources directly or indirectly resulting in the validation of transactions on a blockchain, including the operation of validator nodes (either directly or through an agent), and any activities and commitments of resources closely related thereto.".

(b) Source of Income Related to Consideration Received.

(1) Section 863 of the Internal Revenue Code of 1986 is amended by adding at the end the following new subsection:

"(f) Source of Income Related to Consideration Received. — The source of any income related to digital asset mining or staking activities shall be determined by reference to the residence of the recipient as determined under section 988(a)(3)(B).".

(2) Paragraph (2) of section 864(b) of the Internal Revenue Code of 1986 is amended by redesignating subparagraph (C) as subparagraph (D) and by inserting after subparagraph

(B) the following new subparagraph:

"(C) DIGITAL ASSETS.

(i) IN GENERAL. — Trading in digital assets through a resident broker, commission agent, custodian, digital asset exchange, or other independent agent.

(ii) TRADING FOR TAXPAYER'S OWN ACCOUNT. — Trading in digital assets for the taxpayer's own account, whether by the taxpayer or the taxpayer's employees or through a resident broker, commission agent, custodian, digital asset exchange, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. This clause shall not apply in the case of a dealer in digital assets.

(iii) DEFINITIONS. — For purposes of this subparagraph, the term 'digital asset exchange' means a centralized or decentralized platform which facilitates the transfer of digital assets (as defined in section 6045), and the term 'trading in digital assets' includes mining and staking, as such terms are used in section 451(*l*).

(iv) LIMITATION. — This subparagraph shall apply only if the digital assets are of a kind customarily dealt in on a digital asset exchange and if the transaction is of a kind customarily consummated at such exchange.".

(c) Conforming Amendment. Subparagraph (D) of section 864(b)(2) of the Internal Revenue Code of 1986, as redesignated by subsection (b)(2), is amended by striking "(A)(i) and (B)(i)" and inserting "(A)(i), (B)(i), and (C)(i)".

(d) Effective Date. — The amendment made by this section shall apply to taxable years beginning after the date of enactment of this Act.

Exhibit C – Proposed Legislative History Language

The committee recognizes that the provision relating to the inclusion of income from mining and staking under proposed [section 92 / section 451(l)] relates solely to timing and not to income realization. No negative presumption is intended with respect to the application of longstanding tax principles (including the tripartite definition of income in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955)) that would treat the creation or production of tokens via mining or staking as not giving rise to income. For clarity, the committee believes that under Glenshaw Glass, newly created tokens are not income at the time of creation because there is no clear realization event at such time.

Annex 1 – Legal Analysis

Section 61 of the Internal Revenue Code defines "gross income" as "all income from whatever source derived," but it does not expressly define "income." No express provision of § 61, or any regulation thereunder, treats as gross income an item of property that is created by a person.

It is well established that tax statutes should generally be interpreted by looking to the plain and literal meaning of the statute's language. *See Commissioner v. Soliman,* 506 U.S. 168 (1993). The first definition of "income" in the *Oxford English Dictionary states*, "Coming in."

Likewise, the U.S. Supreme Court, in *Eisner v. Macomber*, held that for something to constitute income, it must involve a "coming in." 252 U.S. 189, 207 (1920). The reasoning in Macomber demonstrates why property created by a taxpayer is not subject to taxation upon creation. Property that a taxpayer creates does not "come in" to the taxpayer; thus, when a taxpayer creates property, the act of creation alone is not a realization event.

For example, when a manufacturer manufactures — that is, creates — products to be sold at a later time, the manufacturer does not have income unless and until its products are sold. In *Tootal Broadhurst Lee Co. v. Commissioner*, the Second Circuit considered whether gross profits from the sale of foreign-manufactured goods in the United States should be sourced in the United States under former section 233(b) of the Revenue Act of 1918. 30 F.2d 239 (2d Cir. 1929), *aff'g* 9 B.T.A. 321 (1927), *cert. denied*, 279 U.S. 861 (1929).

In its analysis, the *Tootal* court said, "Where the same organization makes and sells, the income is earned only upon the sale, and the prior increment flowing from manufacture is not income. It is the entire sum earned which must be taxed, as the statute implies, and this can only follow logically when the sale takes place." *Tootal* was decided in the early days of the income tax when courts established foundational principles that are now so ingrained that more modern courts treat them as axiomatic.

In the landmark case *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955), the U.S. Supreme Court defined "income" as: "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." This test is explicitly conjunctive. Under this test, all three criteria must be met for there to be income. *Glenshaw Glass* is consistent with how the Code and regulations define income—all require that an accession to wealth must be "clearly realized." Created property – like the tokens created and first owned by a staker – is not realized income under the principles of *Glenshaw Glass*: it takes the transaction of selling or disposing of such property for the creator to have income. Thus, for example, a baker who bakes bread and a writer who writes a book are not taxed when they create their bread or their book; rather, they are only taxed when they sell or exchange the property they created. The same applies for tokens newly created through staking and mining.

[1] All Section ("§") references are to the Internal Revenue Code of 1986 (the "Code"), as amended, and the Treasury Regulations ("Treas. Reg.") promulgated thereunder.

Annex 2 – About the Authors

Owl Explains is powered by Ava Labs, Inc., a Brooklyn-based technology company formed in 2018 with the aim of advancing blockchain and related technologies in order to foster greater adoption of this database layer of the internet by working on the Avalanche network, which was launched by a diversified group of validators in September 2020, bringing its novel consensus mechanism and the ability to create custom blockchains to the world. Owl Explains is a project created by the legal team at Ava Labs with the goal of becoming a trusted educational resource for regulators, policymakers, and other stakeholders interested in learning about blockchain technology, cryptoassets, and Web3. Owl Explains also collaborates with academics to give greater exposure to the research being done on these topics.

Fenwick is the premier blockchain tax firm in the country. We leverage our deep institutional knowledge of Web3 with our unparallelled multidisciplinary expertise in tax law, including international, corporate, partnership, transfer pricing, M&A and financial products. Fenwick routinely advises hundreds of clients on tax issues relating to token generation events, private token sales, NFTs, decentralized autonomous organizations (DAOs), and centralized and decentralized cryptocurrency structures. For more information, contact David Forst (dforst@fenwick.com).

CahillNXT is the premier destination for clients seeking counsel to help them resolve their most challenging and important legal and business problems relating to digital assets and the use of emerging technologies. We are entrepreneurial, creative, practical, responsive, and relentless in our efforts to achieve our clients' goals. Leveraging Cahill Gordon & Reindel LLP's more than century-long track record of excellence and innovation in guiding traditional financial institutions through seismic transformations in the structure and regulation of capital formation and trading markets, CahillNXT is now at the forefront of helping clients navigate the maze of risks and opportunities that flow from the world's next great financial revolution arising from the advent of blockchain technology, cryptocurrency, development in web3 activities, and other emerging technologies. For more information, contact Jason Schwartz (jdschwartz@cahill.com).

owlexplains.com, avalabs.org, avax.network, fenwick.com, cahill.com