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May I Pay More? Lessons from Jarrett for Blockchain Tax Policy

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In this article, Parsons examines *Jarrett*, a pending refund suit in which the taxpayers argue that blockchain reward tokens should be included in income only upon sale or exchange (a position that would raise their tax bills), and she explores why they sought this treatment and what implications it holds for policymakers trying to develop a tax regime for blockchain activities.

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I. Introduction

In 2021 Joshua and Jessica Jarrett filed suit for a refund of taxes they paid on staking rewards in 2019. In their initial district court complaint,[1] they argued that the reward tokens Joshua received from staking cryptocurrency should not be considered income at the time of receipt; instead, they should only be considered income upon sale or exchange. Whether their legal argument is valid is an important question for the future of blockchain taxation.[2]

In February, the government gave the Jarretts a full refund and moved to dismiss their suit.[3] The Jarretts responded with a motion to amend their original complaint,[4] clarifying that they are seeking injunctive and declaratory relief. Coin Center submitted an amicus brief[5] in support of the Jarretts' position and the government filed a reply.[6]

But an important and bewildering question is why the taxpayers want to defer tax on the staking income in the first place. Any law student will tell you that the tax treatment sought in *Jarrett* is not desirable. The taxpayers will be giving up the benefit of a preferential long-term capital gains rate on any appreciation in the value of the block rewards. As professor Omri Marian bluntly explained in his recent *Tax Notes Federal* article, "It is just bad tax planning."[7]

Cryptocurrency is considered property for federal income tax purposes.[8] If reward tokens are taxed at the time of receipt, they will be taxed as ordinary income. When a taxpayer later sells the tokens, any appreciation will be capital income and taxed at a favorable long-term capital gains rate (a maximum of 23.8 percent).[9] If the tokens are not considered income until the taxpayer sells or exchanges them, the entire appreciation will be taxed at the higher ordinary income rate (a maximum of 37 percent).[10]

In his article, Marian quantified the cost to the Jarretts of forgoing the preferential capital gains rate, assuming that the reward tokens were sold on December 31, 2021, for their fair market value, which was $40,652.[11] He first calculated the total tax the Jarretts would pay under the IRS's position by including the $9,407 of reward tokens as ordinary income in 2019 and then treating the proceeds from the sale as long-term capital gains. He then calculated the total tax that the Jarretts would pay under the tax treatment they advocate for — no income inclusion in 2019 and taxing the full amount of the sale proceeds as ordinary income in 2021. Marian estimated that the Jarretts' stance would cost them an additional $2,867 in taxes.[12]

So why have the taxpayers taken this position? Or, perhaps more accurately, why are the blockchain interests that are backing this strategic litigation taking this position?[13] This article first considers the reasons provided in support of this tax treatment in the Jarretts' brief.[14] It then considers two alternatives: First, that it is the interests of corporate blockchain participants, not individual taxpayers, that are being represented in this litigation. Second, that blockchain participants plan to avoid paying taxes when they ultimately sell their block rewards, whether through tax evasion or perfectly legal tax planning mechanisms. It then highlights the lessons policymakers can draw from the litigants' position.

II. The Taxpayers' Rationales

The Jarretts' brief sets forth two main rationales for the tax treatment being sought: the administrative burden of including reward tokens as income at the time of receipt and the dilution in the reward tokens' value over time.

A. Administrative Burden

One reason for this "bad tax planning" could be that the administrative burden of reporting staking income at the time of receipt is so great that the taxpayer is willing to sacrifice any potential preferential rate treatment to avoid it. The Jarretts, in fact, highlight compliance difficulties as a practical consideration to support their position.[15] Stakers can receive reward tokens as frequently as every few seconds on some protocols, and the FMV of these reward tokens is extremely volatile. This can make accurately reporting staking income challenging for taxpayers.[16]

Reporting staking income as it is received is certainly more challenging than reporting income from bulk sales of reward tokens. But whether that challenge is so great as to offset the tax advantages of a preferential capital gains rate is far less certain. The most prominent use case for blockchain technology is that it provides a secure, immutable, and transparent record of transactions. There is something disingenuous about participants in that technology saying they cannot handle the burden of reporting blockchain transactions to the IRS. Further, tax software catering specifically to blockchain investors and participants has proliferated in recent years, lowering taxpayers' administrative burdens.[17]

B. Token Value Decline

Another reason that taxpayers might prefer reward tokens not to be included as income until the time of sale is that they expect the value of their tokens to decline over time. The Jarretts' brief suggests this as a possible motivation. The brief discusses how the mechanics of staking in the Tezos blockchain should result in an overall dilution of the token values over time.[18] It would seem most rational to sell an asset whose value you believe will decline if a market for that asset exists. Cryptocurrency exchanges provide that market. However, blockchain participants may expect to receive an overall higher economic return if they retain and stake their new reward tokens in exchange for additional rewards, even if those tokens are steadily declining in value. In that case, the tax treatment requested by the taxpayers in *Jarrett* is rational.

III. Alternative Rationales

But there are other possible reasons to request this tax treatment that are not mentioned in Jarrett's brief, and these reasons can be instructive as policymakers develop laws on the taxation of blockchain. The first is that the interests being represented in this case are not those of individual blockchain participants but corporate players. The second is that blockchain participants never plan to pay taxes on their reward tokens. They plan to avoid tax upon the sale of their reward tokens either through evasion or legitimate tax planning strategies.

A. *Jarrett* Isn't About Individuals

The Jarretts did not bring this litigation on their own. *Jarrett* is a strategic litigation backed by the Proof of Stake Alliance,[19] an advocacy group that brings together "all stakeholders in the proof-of-stake industry,"[20] as well as other anonymous backers.[21] The interests financially backing this litigation may not have the same tax considerations as the Jarretts. As a result, while the proposed treatment may be detrimental to the Jarretts, it may be beneficial to other forces behind the litigation.

The preferential rate for long-term capital gains income is only available to individuals and other noncorporate taxpayers.[22] Corporate taxpayers pay the same tax rate for capital and ordinary income. As a result, the tax treatment requested in *Jarrett* is great tax planning for corporate taxpayers. It allows them to defer income inclusion without forgoing any tax benefits.

Institutional players have flooded the blockchain space. Bitcoin mining, initially the domain of programmers and cypherpunks, quickly became centralized and dominated by companies.[23] Staking could soon become dominated by corporate interests as well. A trend has emerged in which major corporations add cryptocurrency to their balance sheets, with Tesla being perhaps the most visible example.[24] Because block rewards in proof-of-stake networks are typically granted based on the relative number of tokens the participant has staked,[25] the economics of staking lends itself to a concentration of tokens in the hands of major holders. And, unlike bitcoin mining, staking does not require large investments in equipment, electricity, and maintenance costs. It can be delegated to third parties and serve as a passive income source.[26] If corporations could defer paying taxes on that passive income until the time of sale, it would be a major tax advantage. It is possible that the goal of the *Jarrett* litigation is to secure deferral of staking income for corporate interests.

B. Participants Never Plan to Pay Taxes

Another possibility is that blockchain participants never plan to pay taxes on their staking income. They might plan to avoid taxes via evasion. They might plan to take advantage of specific features of U.S. tax law to avoid paying taxes on their staking income legally, or they might hope to secure preferential treatment for blockchain activities in future legislation or regulations.

Tax evasion in the context of cryptocurrency has been a major concern starting from the early days of bitcoin. Concerns about tax evasion make sense considering that cryptocurrency is a technology that was explicitly developed to allow people to transfer cash to one another directly — circumventing the oversight of financial institutions.[27] The IRS relies on information shared by these financial institutions to ensure tax compliance.[28] Cryptocurrency defies the system, and commentators have highlighted this evasion potential.[29]

Requesting tax treatment that would most likely raise the Jarretts' tax burden and that of other noncorporate taxpayers[30] does not assuage these concerns over tax evasion. Not taxing reward tokens until their sale or exchange provides a period during which blockchain participants can move their tokens and scatter them across many different digital wallets.[31] This ability to move funds across wallets, combined with the pseudonymous nature of blockchain transactions, would make it extremely difficult for the IRS to effectively audit blockchain participants and determine whether they did pay taxes on their reward tokens upon their sale or exchange.

Even a tax-compliant blockchain participant would have avenues to entirely avoid taxation on reward tokens if they are not included as income upon receipt. The realization requirement has long been a means to avoid taxation on investment income — a means exploited by the ultrawealthy in particular. David Gamage and John R. Brooks recently estimated that three-fourths of the investment gains of those in the top 0.1 percent of U.S. households are never taxed.[32] The tax treatment sought in *Jarrett* allows blockchain participants to take full advantage of the realization requirement and its potential for infinite deferral of taxes.

If a blockchain participant were to hold reward tokens until death, their heirs would be able to take advantage of the section 1014 stepped-up basis and no taxes would ever be paid on the block rewards.[33]

For those blockchain participants who want to enjoy the economic gains from their block rewards during this life, they could employ what professor Edward McCaffery calls the "buy, borrow, die" method (or, in this case, "stake, borrow, die").[34] Under this method, blockchain participants could use their reward tokens as collateral for loans. They could then use the loan proceeds for current consumption but continue to hold the tokens until death, allowing heirs to take advantage of stepped-up basis. The stake, borrow, die method would not necessarily be the exclusive purview of the ultrawealthy with access to bespoke loan arrangements. Cryptocurrency-backed loans are now commonly available on major crypto exchanges such as Binance and BlockFi.[35]

It is also possible that the crypto interests backing *Jarrett* hope to lobby for favorable new legislation on the tax treatment of cryptocurrency and blockchain, such as like-kind exchange treatment for exchanges of different blockchain network tokens. The deferral of staking income until the time of sale or exchange requested in *Jarrett* could simply be a stalling mechanism until they can achieve those legislative or regulatory goals.

IV. Lessons From *Jarrett*

The tax treatment requested in *Jarrett* is puzzling and should not be accepted at face value. Analyzing the possible motivations for this desired treatment can provide important insights for policymakers and regulators as they grapple with creating a regime to regulate and tax this emerging space.

First, they should recognize that as cryptocurrency and blockchain have become more mainstream, corporate players have joined the game. When crafting a taxing regime for blockchain activities, policymakers must consider the appropriate and desired tax treatment of corporations.

Second, preventing blockchain tax evasion should remain a top concern for the IRS. The increase in IRS enforcement funding in the Inflation Reduction Act (P.L. 117-169), including the specific directive for increased digital asset monitoring and compliance activities, is an important first step.[36]

And, finally, *Jarrett* is yet another reminder of how the realization requirement allows people to escape taxation on appreciated assets. What is on the surface bad tax planning (forgoing a favorable long-term capital gains rate) becomes top-notch tax planning when you consider the potential to permanently escape tax by leveraging the realization requirement.

FOOTNOTES

[1] Complaint, *Jarrett v. United States*, No. 3:21-cv-00419 (M.D. Tenn. 2020).

[2] This question has been explored by other commentators. *See, e.g.,* Omri Marian, "Law, Policy, and the Taxation of Block Rewards," *Tax Notes Federal*, June 6, 2022, p. 1493; Abraham Sutherland, "Cryptocurrency Economics and the Taxation of Block Rewards," *Tax Notes Federal*, Nov. 4, 2019, p. 749; Reuven S. Avi-Yonah and Mohanad Salaimi, "A New Framework for Taxing Cryptocurrencies," SSRN 407139, at 23-27 (Mar. 31, 2022).

[3] Memorandum in Support of United States' Motion to Dismiss, *Jarrett*, No. 3:21-cv-00419 (Feb. 28, 2022).

[4] Memorandum of Law in Opposition to Defendant's Motion to Dismiss, *Jarrett*, No. 3:21-cv-00419 (Mar. 14, 2022).

[5] Brief of Amicus Curiae Coin Center in Support of Plaintiff's Response to Motion to Dismiss, *Jarrett*, No. 3:21-cv-00419 (Mar. 14, 2022).

[6] Reply in Support of United States' Motion to Dismiss, *Jarrett*, No. 3:21-cv-00419 (Mar. 21, 2022).

[7] Marian, *supra* note 2, at 1505.

[8] Notice 2014-21, 2014-16 IRB 938.

[9] Twenty percent tax on long-term capital gains, section 1(h), and 3.8 percent net investment income tax, section 1441.

[10] Section 1(j).

[11] Marian, *supra* note 2, at 1505-1506.

[12] The $2,867 calculation is in net present value terms. *Id.* at 1505.

[13] *See* Joshua Rosenberg, "'Staking' Row Puts IRS on Hot Seat for Lack of Guidance," Law360, Feb. 16, 2022 (explaining that a crypto advocacy alliance as well as other anonymous backers are financially supporting the litigation).

[14] Brief in Support of Taxpayer Joshua Jarrett's 1040-X Amended Return and Claim for Refund, *Jarrett*, No. 3:21-cv-00419 (July 31, 2020). Jarrett submitted this brief along with an amended Form 1040. It is published on the website of one of the litigation's sponsors, Proof of Stake Alliance (last visited Aug. 22, 2022).

[15] Jarrett brief at 31-34.

[16] Recognizing these administrative burdens, some commentators have argued that for policy reasons, staking income should not be recognized until the time of sale or exchange. *See* Avi-Yonah and Salaimi, *supra* note 2, at 27-28.

[17] Examples of these new tax products include CoinTracker, which partnered with TurboTax in 2022; see Julian Dossett, "As Tax Deadline Looms, TurboTax Partners With CoinTracker to Simplify Crypto Reporting," CNET, Mar. 11, 2022; and ZenLedger, which is used by the IRS; see Chris Gaetano, "ZenLedger Renews Contract With IRS," *Accounting Today*, Mar. 1, 2022.

[18] Jarrett brief, *supra* note 14, at 10-11. It argues that, as a result, taxing participants on their reward tokens at the time of receipt is unfair because it would not match the true economic value received by the taxpayer. *Id. See also* Mattia Landoni and Sutherland, "Dilution and True Economic Gain From

Cryptocurrency Block Rewards," *Tax Notes Federal*, Aug. 17, 2020, p. 1213. The validity of this argument is beyond the scope of this article.

19 Proof of Stake Alliance, *supra* note 14.

20 Proof of Stake Alliance, About Us (last visited Aug. 4, 2022).

21 *See* Rosenberg, *supra* note 13.

22 Section 1(h).

23 *See* Quinn DuPont, *Cryptocurrencies and Blockchains* 105 (2019) (describing how a single company, Bitmain, was responsible for 25 percent of the world's bitcoin mining by 2017).

24 Deloitte, "Making Change: Should Bitcoin Be on Your Balance Sheet?" (last visited Aug. 18, 2022) (describing the trend of companies such as MicroStrategy and Tesla adding cryptocurrency to their balance sheets and possible implications).

25 "What Is 'Proof of Work' or 'Proof of Stake'?" Coinbase (last visited Apr. 11, 2022).

26 *Id.*

27 Satoshi Nakamoto, "Bitcoin: A Peer-to-Peer Electronic Cash System" (Oct. 28, 2008). This bitcoin white paper explains that the purpose of the technology is to allow peer-to-peer exchanges without going through a central financial institution.

28 *See* Manoj Viswanathan, "Tax Compliance in a Decentralizing Economy," 34(2) *Ga. St. U. L. Rev.* 283 (2017) ("Tax compliance depends heavily on institutions acting as intermediaries between taxpayers and the Internal Revenue Service (IRS).").

29 *See, e.g., id.* at 321-325 (describing the tax compliance challenges brought by blockchain technology); Marian, "Are Cryptocurrencies Super Tax Havens?" 112 *Mich. L. Rev. First Impressions* 38, 47 (2013) ("Cryptocurrencies offer, at least theoretically, a near-perfect alternative to tax-evaders who can no longer find a safe haven in tax-haven jurisdictions.").

30 This increased tax burden assumes that the reward tokens increase in value in the period between their receipt and sale or exchange by the taxpayer.

31 *See* Marian, *supra* note 29, at 43-44 (outlining this tax evasion technique).

32 David Gamage and John R. Brooks, "Tax Now or Tax Never: Political Optionality and the Case for Current-Assessment Tax Reform," 100 *N.C. L. Rev.* 487, 501-502 (2022).

33 Section 1014.

[34] *See generally* Edward J. McCaffery, "Taxing Wealth Seriously," 70 *Tax L. Rev.* 305 (2017) (analyzing the "buy, borrow, die" method and its implications).

[35] *See* Ryan Wangman, "Crypto-Backed Loans Don't Require a Credit Check, but Your Collateral Isn't Immune to Market Swings," *Business Insider*, Nov. 2, 2021 (describing the widespread availability of crypto-backed loans).

[36] Inflation Reduction Act, section 10301(1)(A)(ii).

END FOOTNOTES