TPC TAX POLICY CENTER
URBAN INSTITUTE & BROOKINGS INSTITUTION

September 7, 2023

The Honorable Ron Wyden
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Mike Crapo
Ranking Member
Committee on Finance
United States Senate
239 Dirksen Senate Office Building
Washington, DC 20510

Re: Balancing the Need for Tax Fairness with the Unique Characteristics of Cryptocurrencies

Dear Chairman Wyden and Ranking Member Crapo:

Thank you for the opportunity to comment on how to best incorporate the evolving digital asset ecosystem into America's tax code. The resources that I cite and to which I link are a part of this comment and should be part of the administrative record.

In this letter, I address one specific issue: the tax treatment of cryptocurrency staking.[1] In my view, the tax code should neither advantage nor disadvantage staking. Instead, the code should tax staking the same way it taxes similar economic activities.

Stakers provide a valuable service by validating blockchain transactions. In return, stakers receive compensation in the form of more tokens. If we want to treat them like other service providers, we should tax stakers on their *net* income. Stakers should pay ordinary income taxes on the rewards they receive and get deductions for the expenses they incur.

There has been vigorous debate about the first part of this recommendation. Some cryptocurrency proponents argue staking reward tokens should not be taxed until sold.[2] In contrast, many traditional tax experts, including the IRS, argue for taxing them at receipt.[3]

I have worked on tax policy for more than twenty years, including as acting director of the Congressional Budget Office and director of the Urban-Brookings Tax Policy Center. On this question, I agree with the traditional tax experts. Stakers are providing a service—secure blockchain transactions—not creating new property. Their rewards should thus be taxed as ordinary income at receipt. Where I differ is in my belief that stakers should also get appropriate deductions for their expenses.

Some expenses of staking are obvious. These include blockchain transaction costs (e.g., gas fees) and the costs of running computers.

But there is also a non-obvious expense: cost recovery. If we want to tax stakers like we tax other service providers, we need to provide appropriate cost recovery deductions for staked tokens.

[1] These views are my own and should not be attributed to the Urban Institute, the Brookings Institution, or the Urban-Brookings Tax Policy Center. This letter draws heavily on "A New Solution for Taxing Cryptocurrency Staking," *TaxVox*, Urban-Brookings Tax Policy Center, July 31, 2023.

[2] For example, Abraham Sutherland, "Phantom Income and the Taxation of New Cryptocurrency Tokens," *Tax Notes*, January 30, 2023.

[3] For example, New York State Bar Association Tax Section, "Cryptocurrency and Other Fungible Digital Assets," No. 1461, April 18, 2022 and Internal Revenue Service, "Revenue Ruling 2023-14", August 2023.

Staked Tokens Should Get Cost Recovery Deductions

The IRS has been very clear that cryptocurrency tokens are property.[4] More precisely, they are a type of intangible property. When staked, this intangible property is used to generate income.

Staking a cryptocurrency is a textbook example of placing property in service to produce income. The owner of the tokens gives up the right to use them in financial transactions or other activities. In return, the owner gets to earn rewards by validating blockchain transactions.[5]

Our tax code almost always provides cost recovery deductions—amortization, depreciation, or depletion—when property is placed in service to produce income. Homeowners, for example, don't get to deduct expenses associated with an idle, spare bedroom. But they do if they start renting it out. Car owners don't get to deduct expenses associated with their family car. But they do if they start offering ridesharing.

The same principle should apply to tokens. If a person just holds tokens in a crypto wallet, they are not using them to produce income and should not get any cost recovery deductions. But if a person places tokens in service by staking them, they do deserve cost recovery deductions to better account for their expenses.

There are two basic ways to provide cost recovery for staked tokens. The first and simplest is to treat staked tokens like other types of intangible property. The second is to create a new approach that tracks how much depreciation staked tokens experience over time.

Treating Staked Tokens as Intangible Property

Staked tokens are the blockchain equivalent of franchise rights or taxi medallions. If you want to serve branded fast food, you need a franchise right. If you want to collect cab fares in New York City, you need a medallion. And if you want to validate transactions on a proof-of-stake blockchain, you need staked tokens.

We have clear rules for cost recovery for franchise rights, taxi medallions, and many other types of intangible property. Under Section 197, taxpayers can amortize the original cost of those intangibles over 15 years.

The simplest way to handle staked tokens would be to treat them the same way. Congress could add staked tokens to the list of Section 197 intangibles. Or, the IRS could recognize staked tokens as the blockchain version of a franchise right. Either way, stakers would get amortization on par with other service providers who use intangible property. This amortization would last only as long as their tokens remain staked. When a person retakes control of their tokens, the deduction would end.

This approach is consistent with existing tax principles, and it treats staked tokens like other forms of intangible property.

Measuring Staked Token Depreciation Over Time

The downside of including tokens under Section 197 is that 15-year amortization is arbitrary. That's true for all types of intangible property, of course. There's no way the economic productivity of goodwill, licenses, trademarks, and franchise rights all decline linearly over 15 years. But given the difficulty of measuring

[4] Internal Revenue Service, "Notice 2014.21," 2014.

[5] For simplicity, I am focusing on a case in which a single person owns tokens, stakes them, validates transactions, and receives token rewards. In practice, staking often involves intermediaries. Those complexities do not change the basic analysis. The owner of the staked tokens deserves cost recovery deductions for putting property in service to produce income.

declines across diverse circumstances, lawmakers decided there is rough justice in lumping them together and allowing cost recovery over 15 years.

There is logic in doing the same for staked tokens. But the rich information provided by blockchains could allow another way. The tax system could use information from the blockchain to track how tokens depreciate over time.

You might wonder whether staked tokens actually depreciate. Does their productive capacity decline over time? The answer is yes. The issuance of new tokens causes staked tokens to depreciate. Each new token can itself be staked to offer validation services. That competition reduces the economic capability of existing tokens.

Suppose a blockchain increases its token supply by 5 percent each year. Tokens that could validate 10 percent of transactions this year might be able to validate only 9.5 percent next year. And only 9 percent the year after. And so on. New staked tokens cause existing staked tokens to gradually become obsolete.[6] Without some unforeseen improvement in market conditions, a person who stakes the same number of tokens each year would see their revenue decline.

Blockchain data allow us to track that depreciation over time. There are some technical details in how you measure this,[7] but the basic idea is simple. If token supply expands 5 percent one year because of staking rewards, stakers could get a deduction of 5 percent of the cost of their tokens. If policymakers prefer a depletion-like approach, the deduction could be linked to staking revenue.

These approaches would be more administratively complex than 15-year amortization under Section 197. But they would allow deductions to more closely track the depreciation experienced by staked tokens.

As noted earlier, the tax debate over staking has focused on how to tax staking rewards. One side favors taxing rewards at receipt. The other favors taxing rewards only when the tokens are sold.

By allowing reasonable cost recovery, lawmakers can chart a middle course. Stakers would pay ordinary income taxes on their staking rewards. But the income tax would be offset by the value of the deductions stakers receive. Those deductions, in turn, would reduce the tax basis of the reward tokens. When those tokens are eventually sold, those deductions would be recaptured. In effect, allowing cost recovery means some rewards are taxed at receipt and some at eventual sale. That is how we tax other service businesses that use property to produce income. It makes sense to do the same for cryptocurrency staking.

Thank you again for the opportunity to submit my thoughts. For questions or to request a follow-up discussion based on this response, please contact Victoria Van de Vate, federal government affairs manager, at vvandevate@urban.org.

Sincerely,

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[6] The tax code explicitly recognizes obsolescence as a reason to give depreciation deductions (section 1.167(a)-9). I am applying this idea in the same spirit with one small change. The tax code focuses on cases in which obsolescence reduces the lifetime of a productive asset. For staking, obsolescence happens gradually over time.

[7] One issue is deciding which changes in token circulation should count as depreciable obsolescence and which do not. The number of tokens in circulation may increase through sales to new investors, for example. Or the number of tokens may fall because of burning mechanisms.