Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Michael R. Fiore
Area Counsel, 1 (Boston)
(Small Business/Self-Employed)

from: Ronald J. Goldstein
Senior Technician Reviewer, Branch 2
(Income Tax & Accounting)

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subject: Frozen Rewards Related to Bankrupt Digital Asset Platforms

This memorandum responds to your request for advice regarding the proper year of inclusion of frozen digital asset rewards in gross income.

Issue

Taxpayer A received rewards from staking and other activities during Year 1 in an account at Digital Asset Platform X (Platform X). Platform X froze the account and filed a Chapter 11 bankruptcy petition after the rewards were credited to Taxpayer A's account but before the end of Year 1. Is Taxpayer A required to include the value of the rewards in gross income in Year 1 if the account remains frozen as of December 31st of Year 1?

Conclusion

Yes. Taxpayer A received the rewards in Year 1 prior to the account being frozen and must include the fair market value of the rewards, at the date and time of receipt, in gross income in Year 1 under Internal Revenue Code (Code) §§ 61 and 451 even though the account remains frozen as of December 31st of Year 1.

Facts

Taxpayer A is an individual cash method taxpayer who in Year 1 held digital assets, including cryptocurrency, in an account at Platform X for investment purposes. Pursuant to the user agreement between Platform X and Taxpayer A ("User Agreement"), rewards, including those from staking, were periodically distributed to Taxpayer A following any applicable lockup or waiting period. At the time the rewards were credited to the account, Taxpayer A was able to sell, exchange, or transfer the rewards. In addition, the User Agreement provided that the credited rewards were property of Taxpayer A. Taxpayer A's account included cryptocurrency received and credited to Taxpayer A's account in Year 1 as rewards from staking and other activities.

During Year 1, Platform X froze its customers' accounts and filed a Chapter 11 bankruptcy petition.[1] As a result of the account being frozen, Taxpayer A was unable to sell, exchange, or transfer any of the digital assets contained in the account, including credited rewards, from the date the account was frozen through December 31st of Year 1.

Law and Analysis

Digital assets are defined under § 6045(g)(3)(D) of the Code as digital representations of value that are recorded on a cryptographically secured distributed ledger.[2] See also Treas. Reg. § 1.6045-1(a)(19)(i). Digital assets do not exist in physical form and include, but are not limited to, property the Internal Revenue Service has previously referred to as convertible virtual currency and cryptocurrency. Notice 2014-21, 2014-16 I.R.B. 938, as modified by Notice 2023-34, 2023-19 I.R.B. 837; Rev. Rul. 2019-24, 2019-44 I.R.B. 1004. Notice 2014-21 provides that convertible virtual currency is treated as property and that general tax principles applicable to property transactions apply to convertible virtual currency.

Cryptocurrency is a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. Units of cryptocurrency are generally referred to as coins or tokens. Distributed ledger technology uses independent digital systems to record, share, and synchronize transactions, the details of which are recorded in multiple places at the same time with no central data store or administration functionality. See Rev. Rul. 2019-24.

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[1] Section 451(i)(4) defines a "frozen deposit" for purposes of interest credited by a qualified financial institution. Although this memorandum refers to frozen accounts and assets, § 451(i) is not applicable because Platform X does not provide interest on deposits and is not a qualified financial institution as defined by §§ 451(i)(5) and 165(l) of the Code.

[2] The Infrastructure Investment and Jobs Act ("the IIJA"), Pub. L. 117-58, div. H, title VI, § 80603(b)(1)(B), added new § 6045(g)(3)(D), which provides this definition of a digital asset for purposes of information reporting by brokers, effective January 1, 2023. The IIJA provides the Secretary with the authority to further define the term "digital asset."

A consensus mechanism is a set of protocols by which nodes reach agreement on updates to the blockchain. In a proof-of-stake consensus mechanism, persons who hold cryptocurrency may participate in the validation process by staking their holdings themselves or may stake their holdings indirectly through a digital asset platform, referred to as a cryptocurrency exchange. See Rev. Rul. 2023-14, 2023-33 I.R.B. 484. In general, digital asset platform user agreements specify the timing for when staking rewards will be credited to a customer's account and made available to the customer to sell, exchange, or transfer.

Section 61(a) provides the general rule that, except as otherwise provided by subtitle A of the Code, gross income means all income from whatever source derived. Specifically, gross income includes, but is not limited to, compensation for services, income derived from business, and gains from dealings in property. Under § 61, "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion," require inclusion in gross income. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). "Gross income includes income realized in any form, whether in money, property, or services." Treas. Reg. § 1.61-1(a). In general, the receipt of property constitutes gross income in the amount of its fair market value at the date and time at which it is reduced to undisputed possession. See, e.g., § 61(a); Koons v. United States, 315 F.2d 542 (9th Cir. 1963); Rooney v. Commissioner, 88 T.C. 523, 526-527 (1987); Treas. Reg. § 1.61-2(d)(1).

Section 451(a) provides that the amount of any item of gross income shall be included in gross income for the taxable year in which it is received by the taxpayer, unless, under the taxpayer's method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. Individual taxpayers generally use the cash method of accounting, pursuant to which gains, profits, and other income are included in gross income in the taxable year in which they are actually or constructively received.[3] Treas. Reg. § 1.451-1(a).

Rev. Rul. 2023-14 provides that if a cash-method taxpayer stakes cryptocurrency native to a proof-of-stake blockchain and receives additional units of cryptocurrency as rewards when validation occurs, 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. The fair market value is determined as of the date and time the taxpayer gains dominion and control over the validation rewards. The same is true if a taxpayer stakes cryptocurrency native to a proof-of-stake blockchain through a cryptocurrency exchange and the taxpayer receives additional units of cryptocurrency as rewards as a result of the validation.

[3] Income, although not actually reduced to a taxpayer's possession, is constructively received by the taxpayer in the taxable year during which it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time, or so that the taxpayer could have drawn upon it during the taxable year if notice of intention to withdraw had been given. Treas. Reg. § 1.451-2(a).

In Year 1, prior to Platform X freezing customers' accounts and filing its bankruptcy petition, Taxpayer A was in actual receipt of cryptocurrency representing staking and other rewards when the cryptocurrency was credited to the account. Pursuant to the User Agreement, Taxpayer could sell, exchange, or transfer the rewards when credited, thereby establishing dominion and control over the rewards and resulting in gross income to Taxpayer A. See § 61; Rev. Rul. 2023-14. The proper year for inclusion of the reward income is Year 1, when the rewards were received by Taxpayer A, notwithstanding subsequent events such as the account being frozen. Treas. Reg. § 1.451-1(a). Accordingly, Taxpayer A must include the fair market value of the rewards received prior to the account being frozen in gross income in Year 1 even though A's account was frozen as of the last day of the year of receipt.[4] The fair market value of the rewards is determined at the date and time the rewards were credited to Taxpayer A's account. See § 61; Rev. Rul. 2023-14; and Treas. Reg. § 1.451-1(a)

If you have any questions, please contact Morgan Lawrence at (202) 317-7011.

Sincerely,

/s/ Ronald J. Goldstein

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[4] In contrast, any rewards that accrued but were not credited to Taxpayer A's account before the account was frozen, for example during a lockup period, would not be includible in income in Year 1 because Taxpayer A could not sell, exchange, or transfer the rewards prior to the account being frozen. Thus, these rewards were not actually or constructively received, and Taxpayer A did not have dominion and control over the rewards, in Year 1.