INATBA REPORT

by the FINANCE WORKING GROUP

Decentralized Finance - “Staking Activities” Brief

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INATBA
International Association
for Trusted Blockchain Applications

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Introduction:

INATBA’s Finance Sub-Working Group is happy to produce this document which was designed to provide clarity on all on-chain “Staking Activities”. Importantly, this document seeks to address considerations taking place alongside the ongoing development of Crypto-Asset taxation frameworks, currently under review by numerous jurisdictions.

The rapid growth of blockchain applications, such as Decentralized Finance (DeFi), has brought forward numerous legal questions, among which the distinction on the placement of tokens within smart contracts, commonly referred to as “Staking”. The term “Staking” has been incorrectly and interchangeably used for numerous different operations within DeFi, something that may cloud clarity, and, thus, regulatory ambitions.

INATBA members hope that by providing clarity on the proper terminology behind Staking, ongoing regulatory efforts will consider the recommendation we provide in this report for the proper regulation of Decentralized activities. As such, it is very important to differentiate between so-called “staking activities” for liquidity provisioning which do not relate to proof-of-stake (POS) activities, which are entirely different processes.

The document will outline how these activities differ, and which activities should be targeted under the term “Staking”. The document concludes with a set of proposed handling methods of these Staking Activities; both for tax considerations and for regulatory considerations. Ultimately, these activities should fall within the proposed Web3 Self-Regulatory framework that has been issued by INATBA’s Finance Working Group.

Importantly, ‘staking’ in the sense of performing validation activities for a proof-of-stake blockchain, is a administerial computer science process that has no inherent connection to a financial activity. With this document, INATBA members aim to provide clarity on how these tools operate and how proof-of-stake public permissionless blockchains utilize cryptocurrencies to ensure the proper functioning of their consensus algorithms, something that in itself should not be considered a taxable event. With this in mind, INATBA members fully oppose any regulatory proposals that may seek to license blockchain validation activities; at present or in the future.

Definitions:

This section aims to provide an overview of proposed definitions on “Staking” and all related technologies and activities.

Proof of Stake:

Proof of Stake (PoS) is a consensus mechanism used by blockchain networks where validators are chosen to validate new transactions and create new blocks based on the number of tokens they hold and are willing to "lock" as an assurance for their honest participation.

Staking:

Staking is the action of committing and locking a certain amount of tokens to participate in transaction validation and block generation activities. By contributing to these activities, participants are generating staking rewards.

Staking plays a crucial role in both securing the network and maintaining its operation. Depending on what PoS consensus mechanism a blockchain uses and how it is technically implemented, token holders can either stake in their own capacity or can delegate to others who will participate on their behalf. Staking in one’s own capacity, and therefore participating as a validator in the blockchain network, usually requires the operation of specialized validation software (nodes). The more tokens a validator stakes, the greater their chances of being selected to generate the next block and receiving the respective staking rewards, aligning their own interests with the network’s. If validators act maliciously or fail to maintain their node's operation (such as by being offline), they risk forfeiting part or all of their staked tokens, losing rewards, or facing reputational repercussions. This mechanism incentivizes that nodes are consistently online, functional, and contributing to the network's integrity and security.

Staking Rewards:

Staking rewards are incentives given to participants who lock their tokens in a PoS network to help secure the blockchain and validate transactions. These rewards are typically distributed in the form of newly minted tokens or transaction fees, and they are proportional to the amount of tokens staked and the participant's role in maintaining network operations.

Liquidity Provisioning / Locking:

This activity is often mislabeled as ‘staking’.

The provision of crypto-assets into a smart contract liquidity pool should not be considered ‘staking’. Use of a liquidity pool (LP) pairs two or more crypto assets into a smart contract token that allows other users to exchange them at the prevailing rate. Users who provide tokens can reclaim a proportionate share of both depending on the relative balance within. Some pools may accumulate fees as a result of user activity from trading.

The ‘staking’ misnomer in a liquidity pool context is when a user that provides tokens to the smart contract could be incentivized to ‘lock’ their position for some time in exchange for additional rewards. Importantly, this activity is distinct from staking and unrelated to staking-like operations. It requires a separate legal assessment.

Delegated Staking:

Delegated staking is a process in PoS networks where token holders who do not want to or cannot run a validator node can delegate their tokens to a validator, allowing them to participate in staking indirectly and often in a non-custodial manner, while retaining the ownership and control of their tokens. The validator uses the combined stake of delegators to increase their chances of being selected to validate transactions and generate new blocks, while both the validator and delegators get a share of the staking rewards.

Delegated staking enhances network security and decentralization by lowering the barrier to participation, allowing even those with smaller token holdings or limited technical knowledge to contribute to the network’s validation process. This broader participation strengthens the network’s resilience, as more users can stake their tokens and support the blockchain without needing to run a validator node themselves, distributing control across a larger group of participants.

Liquid Staking Token (LST):

A liquid utility token that represents the user interaction with smart contract software dedicated to routing cryptocurrency to node operators for the purpose of staking.

To take the example of Ethereum, the most widely supported form of staking:

Unlike traditional ETH staking, which presents burdensome requirements on the individual staker (e.g. 32 ETH, running a validator-related software, obtaining relevant hardware etc), liquid staking allows users to stake any arbitrary amount of ETH and receive a liquid representation of their staked ETH in a new “liquid staking token” (LST). They can broadly be classified into two distinct categories:

- “Active service”, and;
- “Decentralized middleware”.

An active service liquid staking solution, such as Binance ETH (BETH) or Alluvial (lsETH), is typically operated by the underlying centralized node operators, who perform validation activities. The use of an ‘active’ liquid staking service is akin to engaging in a contractual relationship with these identifiable third-party node operators. The software is used as a customer acquisition entryway for new deposits.

A decentralized middleware liquid staking solution, such as Lido stETH (stETH) or Rocket Pool (rETH), separates the software from the underlying validation activity. The software itself functions as a neutral middleware, governing the operations conducted on ETH routed through it, and the participating node operators have no direct say in the parameters or operations of the software. The software itself

separates the validation activity from the user. It is therefore akin to using open-source software, such as SMTP or HTTP protocols.

Layer 1:

Layer 1 Blockchains are the fundamental layer of blockchain technology, serving as the main and independent ledger where transactions are directly processed and verified. It also provides the necessary infrastructure for decentralized applications and smart contracts. A Layer 1 blockchain is the base and foundation of a blockchain network, which operates independently and has its own consensus mechanism and native cryptocurrency.

Layer 2:

A Layer 2 blockchain is a secondary network architecture built on top of a Layer 1 blockchain to improve its scalability and efficiency. It allows faster and more cost-effective transactions by offloading certain tasks, such as transaction processing or smart contract execution, from the main blockchain to an additional layer. Layer 2 solutions interact with the Layer 1 blockchain to maintain security and decentralization while reducing network congestion.

Governance or Voting Rights:

Token voting in governance refers to the capabilities that users of governance tokens have to influence the direction and parameters of a decentralized blockchain-based application (dApp). This is key in the successful implementation of a decentralized protocol. This is sometimes misleadingly referred to as ‘staking’ as there may be incentive mechanisms in place to reward voting participation. However, there is no relation between token ‘staking’ and proof-of-stake staking.

By delegating token voting capabilities to selected delegates or specific governance votes, participants gain the ability to propose, vote on, and implement changes to an application’s parameters in a decentralized manner. This can include decisions on upgrades or changes to parameters. Token voting promotes a democratic and user-driven approach to managing an evolving blockchain ecosystem of applications that often serve an open or public good purpose. This reliance on collective knowledge is one of the big value-adds of blockchain-native organizations.

Custodial Wallet:

A type of virtual assets wallet in which the custody of the assets and private keys are managed by a third party. Under this arrangement, the custodial wallet provider is responsible for safeguarding the cryptographic keys and, by extension, the assets stored therein. In the European Union, custodial wallet services are regulated under the Markets in Crypto-Assets Regulation (MiCAR), which mandates stringent compliance with licensing, cybersecurity standards, and Anti-Money Laundering (AML) processes. These requirements are designed to ensure the security and regulatory compliance of the services provided, classifying custodial wallets as Crypto or Virtual Asset Service Providers (CASP / VASPs)[1].

[1] Or Crypto-asset Service Provider (CASP) in the European Union.

Non-Custodial Wallet:

A type of virtual assets wallet where the customer retains exclusive control over their private keys and thus their assets. This wallet operates as a client or interface that facilitates direct interaction with a decentralized network, enabling customers to independently generate and manage their cryptographic keys without third-party involvement. Non-custodial wallets used for on-chain operations such as staking and lending remain unregulated under the current European Union framework. Technically, custodial and non-custodial wallets can co-exist with a specific platform.

Proposed Tax and AML Handling of Staking Activities:

INATBA's policy proposal for staking activities within DeFi seeks to create a clear tax and regulatory framework that promotes innovation while maintaining compliance. The framework recommends taxation only at the point of off-ramping, meaning users will be taxed when they convert their cryptocurrency tokens or rewards back into fiat or other legal tender via CASPs. This simplifies the tax process for users who hold tokens within DeFi for extended periods without frequent tax events.

The proposal further suggests that, where relevant, capital gains tax should apply to the difference between the cost basis when a user acquired cryptocurrency with fiat or legal tender, and the value when the user exchanges cryptocurrency for fiat or legal tender. For example, if the tokens increase in value while being used as staked assets, users will pay capital gains tax on the difference between the initial and final value, but only at the moment the user decides to exit from cryptocurrencies to fiat currencies or legal tender. This ensures taxes are applied fairly if users profit from the value appreciation of staked assets.

With regards to staking rewards, any cryptocurrency received as part of a staking incentive mechanism should be carefully analyzed before being treated as taxable income. In many cases, these rewards may not qualify as immediate taxable income due to their unique nature within crypto-economic ecosystems. Instead, they could represent an increase in the network's utility rather than genuine income. If the total value remains below or equal to the initial stake, no income or capital gains tax would be applicable, ensuring that users are not taxed on inflationary rewards or minor market fluctuations.

Given that tokens may have a market value, INATBA’s position is that taxable events **should only be recognized at the moment any token is converted into fiat currency or legal tender**. Until then, the user should be considered to be in the process of running distributed software, which in itself should not be a taxable activity.

This stance stems from the notion that many token activities—such as holding, transferring, or participating in decentralized applications—do not necessarily involve the realization of value in a way that traditional tax systems recognize. Token users are often involved in maintaining or using blockchain networks, and these activities may not result in immediate financial gain or liquidity in fiat terms. This position aligns with promoting innovation and reducing unnecessary tax complexities for token users, while still ensuring that governments can tax realized gains when they are monetized into fiat currency. In essence, this approach will:

a) reduce the complexity around tracking numerous token transactions, especially given the volatility of token prices and the difficulty in establishing clear gains until a fiat conversion;

b) lower tax burdens on purely token-to-token transactions or decentralized finance (DeFi) activities would make blockchain technologies more accessible and practical for users;

c) run distributed software (e.g., participating in a blockchain network, staking, or using smart contracts) is framed as technological engagement rather than immediate financial benefit, thereby not triggering taxes until fiat conversion occurs.

For AML and KYC compliance, INATBA suggests that such requirements should only be enforced at the points of on- and off-ramping through regulated Crypto-Asset Service Providers (CASPs). This simplifies compliance for decentralized protocols and operations like staking by ensuring that identity verification and AML checks occur only at key entry and exit points to and from the traditional financial system. This is in line with FATF framework recommendations regarding targeting areas that present risk of money laundering, terrorist financing or illicit use of the financial system. Proof-of-stake validation activities do not present, increase or amplify those risks. Further, INATBA members oppose the introduction of any licensing requirements for POS stakers and validators, since that would create an uncompetitive for any jurisdiction that imposes such rules.

INATBA’s proposal places the compliance burden on regulated CASPs, which are already subject to existing financial regulations. These CASPs, acting as gatekeepers, will be responsible for conducting necessary AML/KYC procedures, removing this obligation from decentralized protocols where no AML/CTF risk mitigation can technically take place, and reducing the administrative burden on individual users.

INATBA emphasizes collaboration between regulators and CASPs to ensure smooth implementation of these policies. The goal is to create a balanced regulatory environment that facilitates DeFi’s growth, simplifies taxation and compliance for users, and provides the necessary oversight to prevent illicit activity within the ecosystem.

Conclusions

The legal question of how to regulate and tax staking activities in decentralized finance (DeFi) requires careful examination and regulatory consideration, as well as clear and accurate definitions for on-chain operations. For INATBA members, such policy considerations are premature, and all compliance burdens should fall onto entries that are already defined under MiCA.

As DeFi continues to evolve, it is crucial to strike a balance between regulatory compliance, investor protection, and fostering innovation. Clear guidelines, robust KYC/AML procedures, smart contract audits, transparent terms, and proactive risk management are key elements to address the legal complexities of staking, but should be addressed through industry self-regulation.

For INATBA members, the taxation of on-chain events, like staking activities as defined above, should take place at the off-ramp of the assets. Importantly, if the value of the off-boarding assets is less than the original on-boarded assets, then no taxable event should occur. The qualification of the taxable event, if any, should be set on a case-by-case basis.

Collaboration between regulatory authorities and industry participants is essential to navigate this evolving landscape and ensure the long-term success and sustainability of decentralized finance. By adopting a measured and thoughtful approach, the legal challenges surrounding staking in DeFi can be effectively addressed while unlocking the transformative potential of this innovative ecosystem.

In conclusion, staking, as a distinct activity, involves locking tokens to support the security and efficiency of a blockchain network, and its rewards serve to align stakeholder incentives rather than creating taxable events. INATBA’s proposal outlines an intelligent framework that will ensure jurisdictional competitiveness and the realization of the innovations that DeFi can bring through staking.

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