



# Sypher Bitcoin Yield Fund



## **Tax Considerations for Earning Income on Bitcoin**

*August 2025*

## Disclaimer

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## I. Introduction

This memorandum provides a summary of the U.S. federal income tax and regulatory considerations relevant to Sypher Bitcoin Yield Fund’s approach to Bitcoin staking compared to other Bitcoin yield-bearing approaches. We believe this is important, particularly for in-kind investors seeking yield through Bitcoin or Bitcoin ETF contributions<sup>1</sup>.

We evaluate whether minting or swapping creates a taxable disposition of Bitcoin under current IRS guidance and whether subsequent rehypothecation of underlying BTC could affect tax treatment. It also outlines the treatment of staking rewards.

Finally, this memorandum addresses common misconceptions stemming from recent regulatory developments, including the SEC’s stance on liquid staking and proposed digital asset market structure legislation.

## II. Minting vs Swapping for staked BTC (“st-BTC”)

Some of the Fund’s strategy involves minting staked BTC (st-BTC) by locking BTC in a trust-minimized protocol. The st-BTC is issued on a 1:1 basis and is fully redeemable for the underlying BTC.

We believe that the act of minting st-BTC is not a taxable event for U.S. federal income tax purposes. This determination is based on the following characteristics:

- **Economic Parity:** st-BTC maintains strict 1:1 parity with BTC.
- **Continuity of Ownership:** Fund retains full economic exposure to the locked BTC.
- **Non-Dispositional Mechanics:** BTC is not sold, exchanged, or transferred.
- **Protocol Design:** st-BTC is minted through a trust-minimized mechanism with no centralized custodian.

A likely interpretation of the facts may be that minting st-BTC does not constitute a sale or exchange under IRC §1001<sup>2</sup>. Tax advisors and legal commentators (e.g., Fried Frank LLP,

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<sup>1</sup> While the IRS has not issued formal crypto-specific guidance on the treatment of in-kind redemptions from digital asset ETFs, current industry practice assumes such redemptions qualify for non-recognition treatment under IRC §852, consistent with the tax treatment of traditional ETFs holding securities or commodities. This practice has not been publicly challenged by the IRS and aligns with the general principles applied to registered investment companies engaging in in-kind redemptions.

<sup>2</sup> IRC §1001 governs the recognition of gain or loss from the sale or exchange of property. Under Treasury Regulation §1.1001-1(a), a realization event occurs when property is exchanged for other property that differs materially in kind or extent.

2022<sup>3</sup>) have analogized similar mechanics, such as ETH → wETH wrapping, as non-taxable transformations due to the absence of a material change in ownership or value.

On the other hand, swapping BTC for a staked, centralized version of BTC (such as via a custodial staking protocol or synthetic wrapped BTC equivalent) could potentially trigger a taxable event under IRC §1001. This is because the transaction may be treated as a taxable exchange under IRC §1001 if the original BTC is exchanged for a materially different asset, particularly if the new token is issued by a third party, is not fully redeemable for BTC, or is subject to rehypothecation. In such cases, the investor's cost basis in the original BTC is applied at the time of the swap, and any gain is recognized immediately. This is especially relevant for holders with low-basis BTC, as the swap could crystallize significant taxable gains even if the transaction appears economically neutral.

### III. Staking Rewards: Tax Treatment

Pursuant to IRS Revenue Ruling 2023-14<sup>4</sup>, staking rewards are treated as ordinary income upon receipt. Therefore, any BTC-denominated yield earned through the Fund's st-BTC-enabled strategies is reported as gross income at fair market value when the Fund obtains dominion and control.

This interpretation is consistent with prevailing guidance from Notice 2014-21<sup>5</sup> and broadly aligns with treatment of mining and other blockchain-based income events.

### IV. Using Investment Funds or Protocols that Rehypothecate

Although minting st-BTC is not considered a taxable event in isolation, the tax analysis may change if the BTC underlying the staked token is subject to rehypothecation (i.e., use as collateral in other transactions, lending, or inclusion in liquidity pools).

If BTC is rehypothecated<sup>6</sup>, the Fund could be deemed to have transferred beneficial ownership of the property. This may constitute a taxable disposition under IRC §1001,

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<sup>3</sup> Fried, Frank, Harris, Shriver & Jacobson LLP, "U.S. Federal Income Tax Considerations for Participants in Decentralized Finance (DeFi) Protocols," January 2022.

<sup>4</sup> Rev. Rul. 2023-14, 2023-33 I.R.B. 361, held that staking rewards received on proof-of-stake networks are taxable as gross income under IRC §61 when the taxpayer gains dominion and control over the rewards, regardless of whether they are immediately sold or retained.

<sup>5</sup> IRS Notice 2014-21, 2014-16 I.R.B. 938, was the IRS's first formal guidance on virtual currency, establishing that convertible virtual currency is treated as property and that general tax principles applicable to property transactions apply to crypto.

<sup>6</sup> While the term "rehypothecation" is not explicitly defined in IRS regulations or rulings, its economic effect—loss of dominion and control over the property—can result in a taxable disposition under IRC §1001.

particularly if the economic or legal rights associated with the BTC are materially altered. Several IRS rulings and commentaries support this position, noting that when control is relinquished or materially different property is received, a realization event may occur. For example, in Chief Counsel Advice 202035011, the IRS emphasized that control and enforceable rights, even in delegated staking scenarios, are key to determining the timing and character of income<sup>7</sup>.

In contrast, Sypher’s architecture explicitly prohibits rehypothecation of locked BTC. All collateral remains isolated and cannot be reused in third-party activities. This maintains alignment with the non-taxable treatment outlined above.

## V. Consequences of Borrowing against Bitcoin

The tax considerations surrounding lending and borrowing against BTC or staked BTC are closely related to those involving rehypothecation. Under U.S. federal tax law, merely pledging property as collateral for a loan does not typically constitute a taxable event. However, the situation becomes materially different if the lender gains control to transfer, sell, or rehypothecate the asset, the IRS may conclude a disposition has occurred.

If BTC or staked BTC posted as collateral is rehypothecated without restrictions or safeguards ensuring continued ownership by the borrower, the IRS could argue that the original holder has effectively disposed of the property. This risk is heightened in cases where the borrower no longer maintains enforceable rights to reclaim the same property (as opposed to equivalent value). This may constitute a realization event under IRC §1001.

Supporting precedent includes Treasury Regulation §1.1001-1(a), which treats exchanges resulting in a materially different asset or shift in rights as taxable. In the context of crypto, this is particularly relevant when loans involve synthetic assets, pooled collateral, or use of platforms that permit collateral rehypothecation.

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<sup>7</sup> CCA 202035011 (Sept. 28, 2020) analyzed delegated staking and concluded that a taxpayer may be treated as having dominion and control over staking rewards when they are generated, if the taxpayer retains a contractual or economic right to those rewards. The memo underscores that constructive ownership and control are central to determining realization, even when custody or validator control is delegated. While not precedential, this CCA offers insight into how the IRS may evaluate control-related risk in staking and rehypothecation scenarios.

<sup>8</sup> *Samueli v. Commissioner*, 132 T.C. 4 (2009). The court denied nonrecognition treatment under IRC §1058 because the taxpayer’s ability to regain the same securities was not sufficiently protected, and the economic benefits of ownership had been surrendered. The case reinforces that ownership continuity and economic control are critical to avoiding realization events—even in loan-like arrangements.

qualify as a non-taxable loan under IRC §1058<sup>9</sup> because the lender lacked the ability to recall the securities on short notice, thereby materially limiting their opportunity for gain and control. Although §1058 applies specifically to securities, the case underscores the IRS and courts' willingness to recharacterize transactions as taxable dispositions when the substance reveals a loss of economic ownership, even if the form suggests otherwise. This principle may apply equally to digital assets posted as collateral in lending protocols that permit rehypothecation, especially where recallability is uncertain or rights are materially altered.

## **VI. Redemption of staked BTC (“st-BTC”)**

The Fund believes the redemption of staked BTC (i.e., burning st-BTC to reclaim BTC) is not a taxable event. This step is generally treated as a non-taxable reversal of the prior minting, provided that 1:1 parity and continuity of ownership are maintained, and no materially different property is received. The BTC recovered is considered the same property initially locked.

This analysis aligns with the logic applied in ETH unwrapping and is further supported by the 1:1 redeemability and trust-minimized custodial design.

## **VII. Clarifications on Current SEC and Legislative Developments**

It is important to clarify that recent SEC guidance on liquid staking, affirming that certain liquid staking tokens may not constitute securities under federal law, does not affect the IRS's interpretation of taxable events. The SEC's regulatory determinations are focused on investor protection and securities classification, and do not address the income tax consequences of crypto transactions.

Accordingly, even if a token issued in a staking transaction is not deemed a security, the IRS may still treat the conversion of BTC into that token as a taxable exchange under IRC §1001 if beneficial ownership is relinquished or if the resulting asset is materially different.

Additionally, the digital asset market structure bill anticipated for late 2025 is not currently expected to create new or clarifying tax guidance. Although the bill may introduce clearer rules around market registration, custody, and asset classification under securities and commodities law, it is not currently drafted to amend the Internal Revenue Code. As such, current IRS rules, including Rev. Rul. 2023-14 and Notice 2014-21, remain controlling.

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<sup>9</sup> IRC §1058 allows for the nonrecognition of gain or loss on the loan of securities if certain conditions are met, including the borrower's obligation to return identical securities, the payment of interest or dividends to the lender, and the lender's ability to terminate the loan and recall the securities on short notice.

### VIII. Basis Sensitivity and Tax Risk

Investors contributing BTC with a low cost basis should be particularly cautious about how that BTC is subsequently deployed to generate yield. While in-kind contributions of property (e.g., under IRC §721<sup>10</sup>) may be non-taxable, subsequent protocol activity that results in a disposition of BTC, such as rehypothecation or custodial staking, could trigger capital gain realization if the cost basis is low.

These risks are compounded in structures where the contributed BTC is swapped for a new token, pooled, or otherwise exposed to third-party control. The potential for gain realization in such instances is high, and LPs with embedded gains should evaluate the downstream implications of any yield strategy that does not preserve original asset continuity.

### IX. Conclusion

Scenario	Taxable Event?	Explanation
BTC → st-BTC (trust-minimized minting)	No	No change in ownership; no exchange under §1001
BTC → Staked Token (via custodial swap/pool)	Yes	Custodial change and new asset likely treated as sale/exchange
BTC → st-BTC then Rehypothecated	Potentially	Beneficial ownership ceded; potential realization under §1001
St-BTC → BTC (redemption)	No	Reversal of minting; no new property received
Staking rewards (BTC yield received)	Yes	Taxable as ordinary income upon receipt (Rev. Rul. 2023-14)

The Sypher Bitcoin Yield Fund’s structure is designed to reduce the likelihood of certain taxable events based on current IRS interpretations. By leveraging a trust-minimized minting process, avoiding any transfer of beneficial ownership, and prohibiting rehypothecation, the Fund maintains the continuity of Bitcoin ownership and believes it preserves the original tax basis. Staking rewards are reported in compliance with IRS rules, and all internal systems support robust basis tracking and documentation.

<sup>10</sup> IRC §721(a) provides that no gain or loss is recognized to a partner or partnership upon the contribution of property to a partnership in exchange for an interest in the partnership, assuming no disguised sale or transfer of liabilities.

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