PAUL HASTINGS

Stay Current

September 2023

Follow @Paul_Hastings

Digital Asset Payment Processors Will Be Required to Report Consumers' Digital Asset Transactions

By Stephen Turanchik & Michael D. Haun

The Internal Revenue Service and Treasury Department have issued long-awaited Proposed Regulations for parties that will be required to report transactions involving digital assets. These newly identified parties will need to file information returns and furnish payee statements on dispositions of digital assets effected for customers in certain sale or exchange transactions.

In its press release, the Treasury Department touted the Proposed Regulations as an effort to crack down on tax cheats while helping law-abiding taxpayers know how much tax they owe on the sale or exchange of digital assets.

The Proposed Regulations provide additional insight into distinguishing which parties must report digital asset transactions and those that will be excused from such reporting. The Infrastructure Investment and Jobs Act ("Infrastructure Act"), passed in 2021, required the reporting of digital assets transactions by any person who, for consideration, was responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.

The Proposed Regulations would require the following persons to report certain sale or exchange transactions of digital assets:

1. brokers,
2. digital asset trading platforms,
3. digital asset payment processors,
4. digital asset hosted wallets,
5. persons who regularly offer to redeem digital assets that were created or issued by that person, and
6. real estate reporting persons.

This Client Alert focuses on brokers and digital asset payment processors.

I. Brokers

Under existing Treasury Regulation § 1.6045-1(a)(1), a broker is defined to mean "any person . . ., U.S. or foreign, that, in the ordinary course of a trade or business during the calendar year, stands ready to effect sales to be made by others." Emphasis added. The term broker is also defined by Internal Revenue Code § 6045(c)(1) to include a dealer, a barter exchange, and any other person who (for consideration) regularly acts as a middleman with respect to property or services. The Infrastructure Act expanded the definition of a broker to include "any person who, for consideration, is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person."

The Proposed Regulations flesh out various activities that will be considered to "effect" sales made by others. Now, any person that provides "facilitative services" that effectuate sales of digital assets by customers will be considered a broker, provided the nature of the person's service arrangement with customers is such that the person ordinarily would know or be in a position to know (i) the identity of the party that makes the sale, and (ii) the nature of the transaction potentially giving rise to gross proceeds.

A "facilitative service" is defined in proposed Treasury Regulation § 1.6045-1(a)(21)(iii)(A) as any service that directly or indirectly effectuates a sale of digital assets, such as providing:

- a party in the sale with access to an automatically executing contract or protocol;
- access to digital asset trading platforms;
- order matching services;
- market making functions to offer buy and sell prices; or
- escrow or escrow-like services to ensure both parties to an exchange act in accordance with their obligations.

Under proposed Treasury Regulation § 1.6045-1(a)(21)(ii)(A), a person is in a position to know the identity of the party that makes the sale if that person maintains *sufficient control or influence* over the facilitative services provided so as to have the ability to set or change the terms under which its services are provided to request that the party making the sale provide that party's name, address, and taxpayer identification number, in advance of the sale.

Likewise, under proposed Treasury Regulation § 1.6045-1(a)(21)(ii)(B), a person is in a position to know the nature of the transaction potentially giving rise to gross proceeds from a sale if that person maintains *sufficient control or influence* over the facilitative services provided so as to have the ability to determine whether and the extent to which the transfer of digital assets involved in a transaction gives rise to gross proceeds.

A person will be considered to be in a position to know the nature of the transaction potentially giving rise to gross proceeds from a sale if the person has the ability to modify an automatically executing contract or protocol to which that person provides access to ensure that this information is provided upon the execution of a sale. This also includes *the ability to change the fees charged for the facilitative services*, whether by modifying the existing service arrangement or by substituting a new service arrangement.

II. Digital Asset Payment Processors

A digital asset payment processor is defined as a person who in the ordinary course of its business regularly stands ready to effect digital sales by facilitating payments from one party to a second party by:

1. regularly facilitating payments from one party to a second party by receiving digital assets from the first party and exchanging those digital assets into cash or different digital assets paid to the second party;
2. acting as a third party settlement organization that facilitates payments, either by making or by submitting instructions to make payments, in one or more digital assets without regard to whether the third party settlement organization contracts with an agent to make, or to submit the instructions to make, such payments; or
3. acting as a payment card issuer that facilitates payments, either by making or by submitting instructions to make payments, in one or more digital assets to a merchant acquiring entity in a transaction that is associated with a payment made by the merchant acquiring entity or its agent.

Sophisticated readers may recognize that the definitions in (2) and (3) already appear in the IRC § 6050W Treasury Regulations. Those Regulations relate to payment settlement entities that are required to report Payment Card and Third Party Network Transactions to merchants on Forms 1099-K if the number of payments to merchants exceeds certain thresholds.

The Proposed Regulations would now require Payment Card Networks and Third Party Settlement Organizations to report to the IRS (and the retail customer) the transfer of the digital assets used to make purchases.

The Proposed Regulations would also require reporting for parties that "regularly facilitate payments" in digital assets from one party to a second party (a merchant). These digital asset payment facilitators may not have an obligation to file Forms 1099-K, but would have an obligation to file a report on the use of the digital asset being used to purchase a good or service.

In some cases, payment recipients are willing to receive payments in digital assets rather than cash and those payments are facilitated by an intermediary. To facilitate a payment transaction in these circumstances, a digital asset payment processor might provide the payment recipient with a temporarily fixed exchange rate on a digital asset payment that is transferred directly from a customer to that payment recipient. This temporarily fixed exchange rate may also be available to the merchant if it wishes to immediately exchange the digital assets for cash.

To address these transactions, the proposed regulations treat the transfer of digital assets to a second person (such as a merchant) pursuant to a processor agreement that provides for the temporary fixing of the exchange rate to be applied to the digital assets received by the merchant as if the digital assets were transferred by the customer to the digital asset payment processor in exchange for different digital assets or cash paid to the second person.

To meet their information reporting obligations in these alternatively structured payment transactions, digital asset payment processors will need to ensure that they obtain the required personal identifying

information (that is, name, address, and tax identification number) from the customer in advance of these transactions.

The IRS has stated that it expects that the digital asset payment processors will report gross proceeds from the disposition of digital assets by customers but may not have the information necessary or available to report the basis of the disposed-of digital assets unless they also hold digital assets for those customers.

Proposed Treasury Regulation § 1.6045-1(a)(2)(ii)(A) clarifies that the "customer" in a digital asset payment processor transaction is the person who transfers the digital assets (or directs the transfer of the digital assets) to the digital asset payment processor to make payment to the merchant. This is the case even if the digital asset payment processor has a contractual arrangement with only with the merchant (and not the consumer).

The Treasury Department and IRS have recognized that requiring retail consumers to provide personal identity information to payment processors may raise privacy concerns. They have requested comments on whether there are alternative approaches that would satisfy tax compliance objectives while reducing privacy concerns.

Because all sales or exchanges of digital assets will result in taxable transactions there is no *de minimis* threshold for digital asset payment processors. The government has rationalized this treatment by stating that taxpayers that engage in a large number of small dispositions of digital assets may have gain or loss that is significant. Additionally, by reporting the digital asset transactions to consumers, the digital asset payment processors will help customers determine the proper amount of gain or loss attributable to such dispositions (despite that there may be no contractual obligation between the processor and the consumer).

III. What Qualifies as a Reportable Digital Asset?

The Infrastructure Act defined a "digital asset" as "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary." The proposed regulations provide that a digital asset does not include cash or fiat currency in digital form such as funds in a bank or payment processor account accessed through the Internet.

In addition, the determination of whether an asset is a digital asset is made without regard to whether each individual transaction involving that digital asset is actually recorded on the cryptographically secured distributed ledger. The use of cryptography, through the use of public and private keys to transfer assets, distinguishes digital assets as defined by the Infrastructure Act from other virtual assets and is therefore an essential part of the definition.

Before issuing the proposed regulation, the Treasury Department and the IRS considered applying these regulations only to virtual currency. The Treasury Department and the IRS also considered whether newer forms of digital assets, such as those referred to as stablecoins or non-fungible tokens ("NFTs"), should be subject to the section 6045 broker reporting rules. The proposed regulations landed on the broader reading such that transactions involving either stablecoins or NFTs are reportable by brokers.

A stablecoin is a digital currency that is pegged to a stable reserve asset like the U.S. dollar, gold, or other stable asset. Stablecoins are designed to reduce volatility relative to unpegged cryptocurrencies like Bitcoin.

NFTs are unique cryptographic tokens that exist on a blockchain and cannot be replicated—thus the “non-fungible” token. They can represent digital items or real-world items like artwork and real estate.

Under the Proposed Regulations both stablecoins and NFTs must be reported. The IRS reasoned that even though the name “stablecoin” is meant to convey stability, the value of a stablecoin may not always be stable and therefore may give rise to gain or loss, and therefore should be reported.

Given that the goal of the proposed regulations is to capture additional taxable transactions and provide taxpayers with information to correctly report their tax liabilities, the definition of digital assets does not apply to other types of virtual assets, such as assets that exist only in a closed system (such as video game tokens that can be purchased with U.S. dollars or other fiat currency but can be used only in-game and that cannot be sold or exchanged outside the game or sold for fiat currency).

Likewise, the Treasury Department and the IRS do not intend for the regulations to apply to uses of distributed ledger technology or similar technology for ordinary commercial purposes that do not create new transferable assets, such as tracking inventory or processing orders for purchase and sale transactions. These transactions are unlikely to give rise to sales as defined for purposes of the regulations.

IV. Retailers

The determination of whether a person qualifies as a broker does not depend on whether that person accepts payment of digital assets in exchange for goods or services. For example, if a stockbroker accepts a digital asset as payment for the commission charged for a stock purchase, the customer’s disposition of the digital asset in exchange for the broker’s services will be treated as a sale of the digital asset for purposes of IRC § 6045 because the stockbroker is a broker due to the fact that it regularly effects sales of stock (not because it regularly accepts digital assets for services).

In contrast, if a landscaper accepts a digital asset as payment for landscaping services, the customer’s disposition of the digital asset in exchange for the landscaper’s services will not be treated as a sale of digital assets for purposes of section 6045 because the determination of whether the landscaper is a broker is made without regard to whether that landscaper regularly accepts digital assets in consideration for landscaping services as part of a trade or business.

V. Information to be Reported

Most of the information that must be reported by brokers is similar to the information that is currently required to be reported on the Form 1099-B with respect to securities. For example, for each digital asset sale the broker must report the following information:

- The customer’s name, address, and taxpayer identification number;
- The name or type of the digital asset sold and the number of units of the digital asset sold;
- The sale date and time;
- The gross proceeds of the sale; and
- Any other information required by the form or instructions in the manner required by the form or instructions.

The Proposed Regulations also require:

- The transaction identification (transaction ID or transaction hash) associated with the digital asset sale, if any;
- The digital asset address (or digital asset addresses if multiple) from which the digital asset was transferred in connection with the sale, if any; and
- Whether the consideration received was cash, different digital assets, other property, or services.

VI. Effective Date

The proposed effective date for brokers to report the gross proceeds from the sale of digital assets is if the sale is effected on or after January 1, 2025.

According to the terms of Proposed Treasury Regulation § 1.6045-1(d)(2)(i)(C), brokers are required to report the adjusted basis and the character of any gain or loss with respect to a sale if the sale or exchange is effected on or after January 1, 2026.

VII. Request for Comments

The Treasury Department and IRS have requested comments on 51 separate topics in the Proposed Regulations. Those comments must be received by October 30, 2023.

A public hearing has been scheduled for November 7, 2023 at the IRS Office at 1111 Constitution Avenue, NW, Washington, D.C.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings Los Angeles lawyers:

Michael D. Haun
1.213.683.6119
michaelhaun@paulhastings.com

Stephen J. Turanchik
1.213.683.6187
stephenturanchik@paulhastings.com

Paul Hastings LLP

Stay Current is published solely for the interests of friends and clients of Paul Hastings LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2023 Paul Hastings LLP.