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IRS Issues Proposed Regulations for Digital Asset Reporting

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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 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 asset transactions by any person who, for consideration, was responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.

If read broadly, this requirement from the Infrastructure Act could have required reporting from persons who could not possible comply, including hardware sellers and software developers. 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.

Each of these categories is discussed more fully below.

There is some welcome news in the Proposed Regulations for parties who might be required to report digital asset transactions under the Infrastructure Act, but would not have access to the information that was required to be reported.

The term “broker” does not extend to (i) merchants who sell goods or services in return for digital assets, (ii) persons who are solely engaged in the business of validating distributed ledger transactions through proof-of-work, proof-of-stake, or any other consensus mechanism, without providing other functions or services, and (iii) persons who are solely engaged in the business of selling hardware or licensing software, the sole function of which is to permit a person to control private keys which are used for accessing digital assets on a distributed ledger, without providing other functions or services.

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 a 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. The fact that a digital asset trading platform operator has modified an automatically executing contract or protocol in the past strongly suggests that the operator has sufficient control or influence over the facilitative services.

This rule is intended to limit the definition of broker to persons who have the ability to obtain information that is relevant for tax compliance purposes. It recognizes the fact that some digital asset trading platforms that have a policy of not requesting customer information (or requesting only limited information) have the ability to obtain information about their customers by updating their protocols as they do with other upgrades to their platforms. The ability to modify the operation of a platform to obtain customer information is treated as being in a position to know that information.

A. Stakers, Miners, Validators

Because some persons providing these facilitative services or products may not be in a position to know the identity of the parties making a sale and the nature of the transaction, proposed Treasury Regulation § 1.6045-1(a)(21)(iii)(A) specifically excludes from the definition of facilitative service persons solely engaged in the business of providing distributed ledger validation services—whether through proof-of-work, proof-of-stake, or any other similar consensus mechanism—without providing other functions or services.

B. Hardware Sellers, Software Providers

For the same reason, proposed Treasury Regulation § 1.6045-1(a)(21)(iii)(A) also excludes from the definition of facilitative service persons solely engaged in the business of selling hardware or licensing software for which the sole function is to permit persons to control private keys which are used for accessing digital assets on a distributed ledger.

This exclusion does not, however, exclude wallet software providers from the definition of facilitative service if the software also provides users with direct access to trading platforms from the wallet platform.

C. Decentralized Autonomous Exchanges

The IRS expects that the proposed definition of broker will ultimately require operators of some platforms generally referred to as decentralized exchanges to collect customer information and report sales information about their customers, if those operators otherwise qualify as brokers. The fact that a decentralized exchange does not operate with a corporate existence does not excuse the exchange from these rules. Treasury Regulation § 301.7701-3(b) provides that the term "person" includes a business entity that is treated as an association or a partnership for Federal tax purposes. Accordingly, a group of persons providing facilitative services that are in a position to know the customer's identity and the nature of the transaction effectuated by customers may be treated as a broker whether or not the group operates through a legal entity. This includes decentralized exchanges.

In the Explanation of Provisions, the IRS noted that there can be a range of effective control based on how widely the tokens are disbursed and whether or not a group of persons (normally the

founders/development teams/investors) retain enough tokens as a group to make decisions. Decentralized autonomous organizations (DAOs) are examples of this organizational structure. Even in structures where governance tokens may be widely distributed, individuals or groups of token holders can have the ability to maintain practical control. In addition, in some cases, so-called "administration keys" exist to allow developers or founders to modify or replace the automatically executing contracts or protocols underpinning digital asset trading platforms without requiring the vote of governance token holders.

The IRS justifies this position by noting that (i) customers need information about gross proceeds and basis to prepare their tax returns; (ii) the IRS needs that information in order to collect the taxes that are imposed under laws enacted by Congress and in order to focus its compliance efforts on taxpayers who fail to comply with their obligations to report their tax liability; and (iii) policy makers need that information in order to understand what taxpayers are doing so that they can make informed judgments about further laws or other guidance relating to digital assets.

II. Digital Asset Trading Platforms

The term "broker" includes online businesses, such as operators of trading platforms that hold custody of their customers' digital assets and operators with sufficient control or influence over non-custodial trading platforms that effect sales of digital assets made for others by providing access to automatically executing contracts, protocols, or other software programs that automatically effect sales.

Digital asset trading platforms that also provide custodial (hosted wallet) services, operators of non-custodial trading platforms (including platforms that effect transactions through automatically executing contracts or protocols) are included as examples of persons who in the ordinary course of their trade or business stand ready to effect sales of digital assets on behalf of customers. These examples also clarify that even if a person's principal business does not meet the definition of broker, the person will be considered a broker under the definition if that person also regularly stands ready to effect sales of digital assets on behalf of customers. Thus, digital asset hosted wallet providers and persons who sell or license software to unhosted wallet users will be considered brokers if they also facilitate or offer services to facilitate the purchase or sale of digital assets.

An operator of a digital asset trading platform that is an individual or legal entity may be treated as a broker. An operator of a digital asset trading platform that is comprised of a group that shares fees from the operation of the trading platform, or is otherwise treated as an association or a partnership (including a DAO), may also be treated as a broker even though there is no centralized legal entity through which trades are carried out.

III. 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 submitting instructions to make payments, using 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 submitting the instruction 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.

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, for purposes of the definition of a digital asset payment processor, 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 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.

In addition, because a payment processor knows the gross proceeds with respect to an exchange transaction that transaction may also be reportable to the merchants on Form 1099-K.

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 the merchant.

IV. Digital Asset Hosted Wallets

In the digital asset industry, some persons stand ready in the ordinary course of a trade or business to take custody of and electronically store the public and private keys to digital assets held on behalf of others. These digital asset hosted wallet providers in some cases also effect sales or possess information regarding the digital asset sales of their customers in much the way a bank custodian or other custodian does for securities.

The proposed definition of broker includes such a digital asset hosted wallet provider to the extent that the digital asset hosted wallet provider (i) functions as a principal in the sale of digital assets, (ii) acts as an agent for a party in the sale if it would ordinarily know the gross proceeds from the sale, or (iii)

acts as a digital asset middleman and would ordinarily know or be in a position to know the identity of the party that makes the sale and the gross proceeds from the sale.

If a hosted wallet provider solely holds and transfers digital assets on behalf of its customers, without possessing, or having the ability to possess, any knowledge of gross proceeds from sales, the hosted wallet provider would not qualify as a broker.

V. Persons Who Regularly Offer to Redeem Digital Assets that were Created or Issued by that Person

Under current Treasury Regulation § 1.6045-1(b), an obligor that regularly issues and retires its own debt obligations is a broker. That obligor will be treated as effecting a sale when it retires its own debt as part of those regular activities. Similarly, a corporation that regularly issues and redeems its own stock will be treated as effecting a sale when it redeems its own shares as part of these regular activities.

The proposed regulations would amend the definition of a broker to include a person that regularly offers to redeem digital assets that were created or issued by that person.

VI. Real Estate Reporting Persons

Current Treasury Regulation provides that if a real estate reporting person, as defined in existing Treasury Regulation § 1.6045-4(e), is involved in a real estate transaction in which the real estate buyer uses digital assets as consideration in the exchange for real property, that disposition of digital assets in exchange for real property will be treated as a sale of the digital assets by that real estate buyer.

VII. 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 <u>not</u> 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 to only 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 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 include 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.

VIII. 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.

IX. 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.

To the extent the sale is of a digital asset that was held by the broker in a hosted wallet on behalf of the customer and that digital asset was previously transferred into that account (transferred-in digital asset), the broker must also report:

- The date and time of such transfer-in transaction,
- The transaction ID of such transfer-in transaction,
- The digital asset address (or addresses)—the unique set of alphanumeric characters that is generated by the transferee wallet—from which the transferred-in digital asset was transferred, and
- The number of units transferred in by the customer as part of that transfer-in transaction.

There are going to be significant challenges for brokers to comply with these rules, and the IRS has recognized some of those difficulties.

A. Allocation of Transaction Fees

Oftentimes, a broker will charge a single transaction fee in the case of an exchange of one digital asset for a different digital asset. The Proposed Regulations suggest that if one digital asset is exchanged for another digital asset, one-half of the fees should be allocated to the disposed asset and one-half of the fees allocated to the received asset.

B. Determining Customer's Basis in Digital Assets

When brokers acquire a digital asset on behalf of a customer, it should be straightforward to determine the basis in the acquired asset because the broker has reason to know the cost of the acquired asset. However, if a broker takes custody of an asset that is transferred by a customer, the broker may not have reason to know of the basis in that asset. Consequently, the Proposed Regulations only require mandatory basis reporting for sales of digital assets that were previously acquired, held until sale, and then sold by a custodial broker for the benefit of a customer.

C. Specific Identification / FIFO

If a customer sells less than its entire interest in a digital asset, the Proposed Regulations allow the customer to specifically identify which portion of the digital asset the customer wants sold. In order to accomplish this, a customer must notify the broker no later than the date and time of sale which units of a type of digital asset it is selling. Otherwise, the broker must report the sale based on the first-in / first-out ("FIFO") methodology.

X. 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.

XI. 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.

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

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