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Treasury Department Issues Proposed Regulations for Brokers of 'Digital Assets'

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On August 25, 2023, the US Department of the Treasury issued proposed regulations that would impose new information reporting requirements for brokers that facilitate certain transactions involving "digital assets" – if finalized in their present form. The proposed regulations were issued to implement certain changes to Section 6045 of the Internal Revenue Code of 1986, as amended, made by the Infrastructure Investment and Jobs Act (IIJA) to improve tax administration and compliance with respect to trading and investing in digital assets.[1]

What is a 'digital asset'?

For purposes of the proposed regulations, a "digital asset" is a digital representation of value that is recorded on a cryptographically secured distributed ledger (or any similar technology), without regard to whether each individual transaction involving that digital asset is actually recorded on that ledger. Cryptocurrencies, non-fungible tokens (NFTs) and stablecoins generally would be considered digital assets under this definition.

The US dollar or a foreign currency (i.e., fiat currency) in digital form (such as funds held in an online account with a bank or payment processor) and virtual assets that exist only in a closed system (such as video game tokens that can only be used in game and cannot be sold or exchanged outside the game or sold for fiat currency) would not be considered digital assets under this definition.

Under the proposed regulations, the sale of an asset that qualifies both as a security and as a digital asset must be reported only as a sale of a digital asset, although brokers also may be required to provide additional information for these sales. A similar coordination rule is provided for the sale of an asset that qualifies both as a commodity and as a digital asset.

Who would be considered a 'broker' with respect to digital assets?

Any person that in the ordinary course of a trade or business stands ready to effect sales of digital assets to be made by others would be considered a "broker" for purposes of the proposed regulations. A broker also would include a person that regularly offers to redeem digital assets that were created or issued by that person (even if the person actually makes redemptions only occasionally), such as digital assets issued in initial coin offerings or redemptions of stablecoins.

A broker also would include a "digital asset middleman" that provides facilitative services that effectuate sales of digital assets by customers, provided that the nature of the service arrangement is such that the person ordinarily would know or be in a position to know the identity of the party that makes the sale and the nature of the transaction potentially giving rise to gross proceeds.

A facilitative service is defined in the proposed regulations 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 smart 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.

These definitions are intended to limit brokers to persons who have the ability to obtain information that is relevant for tax compliance purposes, but would include decentralized exchanges that currently may have a policy of not requesting (or making only limited requests for) customer information – but could update their

smart contracts or protocols to obtain additional customer information. Thus, digital asset trading platforms that also provide hosted wallet services, certain unhosted wallet providers, operators of non-custodial trading platforms or websites (including those that effectuate trades through smart contracts or protocols), digital asset payment processors, and operators and owners of physical electronic terminals or kiosks to effect sales of digital assets generally would be subject to reporting under the proposed regulations.

The preamble to the proposed regulations observes that founders, development teams or investors may have the ability to control changes to a decentralized exchange platform or to modify or replace smart contracts, or a holder of a significant amount of governance tokens may routinely take actions on behalf of the platform, and therefore could come within the definition of a broker for purposes of the proposed regulations. The Treasury Department and the IRS recognize that some stakeholders may have privacy concerns with providing personal identity information to decentralized exchanges and have requested comments on alternative approaches that could reduce these concerns while satisfying tax compliance objectives.

Persons solely engaged in the business of providing distributed ledger validation services (e.g., miners and stakers) or selling hardware or licensing software for which the sole function is to permit persons to control private keys used for accessing digital assets on a distributed ledger generally would not be considered to provide facilitative services. However, the provision of wallet software would not be excluded from the definition of facilitative services if the software also provides users with direct access to trading platforms from the wallet platform.

Which transactions involving digital assets would be subject to reporting?

A “sale” that is subject to reporting under the proposed regulations generally includes exchanges of digital assets for cash, stored-value cards (such as gift cards), different digital assets, property of a type that is subject to reporting under Section 6045 (such as securities or real property) or broker services.

A person that is already a broker under existing law and that accepts digital assets from a customer as payment will be subject to the reporting requirements of the proposed regulations. For example, if a stockbroker accepts a digital asset as payment from a customer, the customer generally will recognize gain or loss on the disposition of the digital asset (as set forth in existing IRS guidance). In that case, the stockbroker generally will be required to file an information return and provide information to the customer with respect to this disposition, regardless of whether the broker – regularly as part of its trade or business – accepts digital assets as consideration.

Transactions that would not be considered a “sale” include the receipt of new digital assets without disposing of something else in exchange (e.g., digital assets received from an airdrop or a hard fork), and the receipt of digital assets in exchange for services by a person that is not a broker within the meaning of Section 6045, such as a reward for marketing-related services (e.g., completing a survey).

The proposed regulations do not address whether reporting is required for a loan of digital assets, a transfer of digital assets to and from a liquidity pool by a liquidity pool provider, or the wrapping and unwrapping of digital assets.

What information would need to be reported?

Brokers of sales involving digital assets would be required to report certain information that generally is similar to the information reported on IRS Form 1099-B with respect to securities –including the customer’s name, address and taxpayer identification number; the name or type of digital asset sold and the number of units sold; the date and time of the sale; and the gross proceeds of the sale. In addition, brokers would be required to report the transaction identification or hash for the digital asset sale, the digital asset address(es) from which the digital asset was transferred, and whether the consideration received was cash, different digital assets, other property or services. Brokers would be required to report this information on a new tax form (IRS Form 1099-DA).

The proposed regulations would further require certain digital asset brokers to report cost basis information with respect to digital assets, which would be treated as “covered securities.” Until future rulemaking under Section 6045A is complete, mandatory basis reporting would be limited to digital assets that are acquired in a customer’s

account by a broker providing hosted wallet services in exchange for cash, stored-value cards, different digital assets, property of a type that is subject to reporting under Section 6045 (such as securities or real property) or broker services. Sales transactions effected by custodial brokers of digital assets that were not previously acquired in the customer's account and sale transactions effected by non-custodial brokers, such as decentralized exchanges, are not subject to mandatory basis reporting until future regulations are promulgated.

Although mandatory basis reporting would not take effect until January 1, 2026, it would apply with respect to digital assets that were acquired in an account on or after January 1, 2023. Digital asset brokers therefore should consider implementing systems to implement cost basis tracking in anticipation of the finalization of these rules. However, in the preamble to the proposed regulations, the Treasury Department and the IRS requested comments on whether the requirements should apply only to digital assets acquired on a date after the finalization of the proposed regulations.

Do the proposed regulations apply to sales effected outside the United States or to foreign persons?

The proposed regulations classify a broker as a US digital asset broker, controlled foreign corporation (CFC) digital asset broker or non-US digital asset broker, and provide rules for determining the location of a digital asset sale for each type of broker. The reporting requirements generally are more stringent for US digital asset brokers and CFC digital asset brokers than for non-US digital asset brokers.

All sales of digital assets by a US digital asset broker are considered effected at an office inside the United States, and the broker is required to report information with respect to sales effected for its customers – unless the broker can treat the customer as an exempt recipient under existing rules or as an exempt foreign person under certain proposed presumption rules, or on the basis of certain tax documentation. If a CFC digital asset broker or a non-US digital asset broker conducts activities as a "money services business" within the meaning of the Bank Secrecy Act,[2] the broker generally will be subject to the same rules as a US digital asset broker. The Treasury Department and the IRS are considering extending this rule to CFC digital asset brokers and non-US digital asset brokers that are regulated by other US regulators, on the basis that these brokers may have sufficient contacts with the United States to warrant the same diligence and reporting rules as those that apply to US digital asset brokers.

Sales effected by a CFC digital asset broker not conducting activities as a money services business are considered effected at an office outside the United States, but nevertheless are required to be reported under the proposed regulations – unless effected for an exempt recipient or an exempt foreign person. This is consistent with existing regulations for securities brokers, which require CFCs to report on sales effected inside or outside the United States unless an exception applies.

Sales by a non-US digital asset broker not conducting activities as a money services business generally are treated as effected at an office outside the United States – unless the broker collects documentation or information (e.g., under applicable anti-money laundering rules) indicating that the customer has connections to the United States or may be a US person. In the absence of such an indication, this type of non-US digital asset broker would not be considered a broker and would not be required to report the sale. If such an indication exists, the sale is treated as effected at an office inside the United States, and the non-US digital asset broker is required to report sales effected on behalf of this customer after the broker obtains that documentation or information – unless the broker determines that the customer is an exempt foreign person or an exempt recipient, or the broker closes the account before effecting the sale for the customer.

When would the proposed regulations apply if finalized in their present form?

The proposed regulations would require brokers to report the gross proceeds from sales of digital assets effected on or after January 1, 2025. Brokers also would be required to report the adjusted basis and character of gain or loss for sales of digital assets that constitute "covered securities" (within the meaning of Treasury Department regulations, Section 1.6045-1(a)(15)) that are effected on or after January 1, 2026, with respect to digital assets that were acquired in an account on or after January 1, 2023. As noted above, until future rulemaking under Section 6045A is complete, basis reporting is limited to digital assets that are acquired in a

customer's account by a broker providing hosted wallet services.

Notes

1. Under the IIJA, information reporting requirements for digital assets would have applied to taxpayers who disposed of digital assets beginning after December 31, 2022. However, on December 23, 2022, the IRS issued Announcement 2023-2, which delayed information reporting by brokers with respect to dispositions or transfers of digital assets until final regulations were issued.
2. 31 USC 5311 et seq.

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