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Client Alert

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United States: Crypto Regulations Proposed by Treasury

Tax News and Developments

In brief

On 25 August 2023, the United States Treasury Department issued a notice of proposed rulemaking regarding tax reporting by brokers of transactions involving the sale or exchange of digital assets (the "Proposed Regulations").[1] These long-awaited Proposed Regulations are in response to section 80603 of the Infrastructure Investment and Jobs Act of 2021, which expanded the scope of information reporting obligations for brokers under Code section 6045 to cover transfers of digital assets.[2]

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Key takeaways

- **Effective dates:** Brokers are required to report gross proceeds from sales of digital assets effected on or after 1 January 2025. Reporting of adjusted basis and character of gain or loss is required for sales effected on or after 1 January 2026. The rules for determining gain or loss and cost basis for digital assets are effective for all sales and acquisitions on or after January 1 of the calendar year immediately following the publication of final regulations in the Federal Register.
- **What is a digital asset?** Any digital representation of value that is recorded on a cryptographically secured distributed ledger, including NFTs and stablecoins.
- **Who is a broker?** Any person (US or foreign) who in the ordinary course of a trade or business stands ready to effect sales of digital assets to be made by others. Miners and validators are not brokers, as long as they do not perform other functions or services in addition to validation services. But providers of decentralized finance and unhosted wallet services are brokers if their services directly or indirectly effectuate sales of digital assets and the provider earns fees from these digital asset sales. Persons involved in real estate transactions where digital assets are used as consideration can also be treated as brokers.
- **What information must be reported?** In addition to name, address, and taxpayer ID, the information required to be collected and reported includes wallet addresses and blockchain transaction IDs, which could have serious privacy implications given the ease with which financial histories can be reconstructed from blockchain records.
- **Deadline to submit comments:** 30 October 2023.

[1] REG-1227893-19, 88 Fed. Reg. 59,576 (Aug. 29, 2023) (hereinafter "Notice of Proposed Rulemaking").

[2] Unless otherwise indicated, all section references are to the US Internal Revenue Code of 1986 (the "Code"), as amended, and the US Treasury Regulations.

Background

Section 6045 requires "brokers" to file information returns with regard to customer transactions involving certain assets, including "specified securities". As part of the Infrastructure Investment and Jobs Act (the "Act"), which was enacted in November 2021, Congress expanded the definition of broker in section 6045(c)(1) to include "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person."[3] The Act also expanded the definition of specified securities to include "any digital asset," which it defined in section 6045(g)(3)(D) to mean "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary." This marked the first time that digital asset was defined in the Code, as previous IRS guidance referred to "virtual currency" rather than digital assets (e.g., Notice 2014-21). Section 6045A, which provides information reporting rules in connection with transfers of covered securities to brokers,[4] was also expanded to require information reporting for transactions where a broker transfers a covered security that is a digital asset from an account maintained by such broker to an account that is maintained by a non-broker.

The intention of these rules was to treat cryptocurrency exchanges like stock brokerages and to ensure that taxpayers who were regularly trading cryptocurrency would comply with their tax obligations upon the sale or exchange of cryptocurrency given that information regarding their transactions would be reported directly to the IRS by the cryptocurrency exchanges. These rules were initially intended to become effective for brokers of digital assets on 1 January 2023. The regulations implementing these rules were delayed, however, creating confusion among cryptocurrency exchanges and tax practitioners as to how to properly comply with these rules.

In February 2022, Jonathan Davidson (the Assistant Secretary for Legislative Affairs) issued a letter to members of Congress in which he acknowledged concerns regarding the potential application of these rules to parties lacking adequate knowledge of the relevant sales transactions and confirmed that ancillary parties who cannot access information that is useful to the IRS are not intended to be captured by the information reporting requirements. This was welcome news to many in the crypto industry and the tax community who were concerned that the broad statutory language might be interpreted by some as including unintended third parties, such as cryptocurrency miners and stakers, within the definition of broker.

In light of the looming effective date for reporting by digital asset brokers, Treasury and the IRS declared in Announcement 2023-2, issued on 23 December 2022, that brokers will not be required to report information regarding the disposition of digital assets until regulations are issued under sections 6045 and 6045A. In February 2023, Treasury and the IRS released an update to their 2022-2023 Priority Guidance Plan, which included regulations to implement the digital asset reporting rules under sections 6045 and 6045A. On 1 August 2023, Senators Warren, Casey, Blumenthal, and Sanders wrote a letter to Treasury Secretary Janet Yellen and IRS Commissioner Daniel Werfel in which they voiced their impatience over the delayed release of the information reporting regulations and pressed for answers on the delay. A few weeks later, the Proposed Regulations were released.

Applying the Section 6045 Reporting Rules to Digital Assets

As noted above, the Infrastructure Investment and Jobs Act of 2021 amended section 6045 to include digital assets within the definition of a specified security, and to add a new category of brokers who effectuate transfers of digital assets on behalf of others. This section will address the provisions in the Proposed Regulations intended to implement these two major changes, then touch on some of the provisions in the Proposed Regulations that address additional issues with applying section 6045 to digital assets.

Definition of digital assets

The Proposed Regulations define a digital asset as "any 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

[3] Section 6045(c)(1)(D).

[4] Covered securities are a subset of specified securities and are enumerated in Treas. Reg. §1.6045-1(a)(15).

actually recorded on that ledger, and that is not cash."[5] This definition is a bit longer than the definition in the statute, and we address below the significance of the language in each of the three clauses in the sentence.

Treasury views the use of cryptography in the transfer of "digital assets" as a key feature that distinguishes these assets from other sorts of virtual assets or digital content that are not subject to the reporting rules under section 6045.[6] For example, the preamble to the Proposed Regulations notes that the definition of digital assets does not apply to virtual assets that only exist in a closed system, such as in-game assets and tokens that can be purchased with fiat currency, but which can only be used in-game and cannot be sold outside the game or for fiat currency.[7] The implication is that transfers of the in-game assets and tokens in this example are not recorded on a blockchain or otherwise cryptographically secured. The term "digital assets" as used in the Proposed Regulations, however, is broadly applicable to almost any digital representation of value on a blockchain, regardless of the purpose of the asset. For example, after some consideration Treasury decided to apply the reporting rules to sales of non-fungible tokens (NFTs) despite concerns that this could lead to inconsistent tax reporting of a transfer of a tokenized asset as compared to a transfer of the underlying real-world asset in non-tokenized form.[8]

> *Observation: It is unclear how digital representations of value on a blockchain, such as NFTs, that are used for a specific purpose, such as gaming, but which are not widely used and cannot be sold outside the game for fiat currency, would be treated under these rules.*

The purpose of the middle clause in the definition of "digital asset" is to make clear that assets held in a custodial account or on account of the broker itself are still considered digital assets and are subject to the broker reporting rules, even though individual customer transactions may not be separately recorded on chain. So the sale of a digital asset that is held in a customer account on a centralized crypto exchange would still be subject to the broker reporting rules, even if the sale is only recorded by the exchange on its internal books and records, as long as units of the digital asset are held on chain by the exchange in its capacity as custodian.[9]

The term "cash" means US dollars or any convertible foreign currency that is issued by a government or a central bank, whether in physical or digital form.[10] The preamble to the Proposed Regulations notes that fiat currency balances in a bank or other payment processor account that is accessible over the Internet are not considered digital assets under these rules.[11] The preamble also acknowledges that central bank digital currencies (CBDCs) may be considered cash and not digital assets under these rules.[12] However, privately issued stablecoins are not cash and are therefore subject to the broker reporting rules. Treasury acknowledged that certain stablecoins, particularly those that are 100% backed by the US dollar or other foreign currency, have prices that are more closely pegged to the underlying currency, and therefore Treasury has requested comments on whether stablecoins, or some subset of stablecoins, should not be subject to the broker reporting rules.[13] Treasury has also requested comments on the proper treatment of tokenized deposits or other tokenized assets that are closely tied to cash in a bank account.[14]

> *Observation: Treasury suggests that stablecoins can be excluded from the broker reporting rules either by analogizing them to cash or by excluding transactions involving the disposition of stablecoins linked to the US dollar or other foreign currencies from the definition of a sale, for which reporting is required.*

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[5] Prop. Treas. Reg. §1.6045-1(a)(19)(i).

[6] REG-1227893-19, 88 Fed. Reg. at 59,581.

[7] REG-1227893-19, 88 Fed. Reg. at 59,582.

[8] REG-1227893-19, 88 Fed. Reg. at 59,582.

[9] REG-1227893-19, 88 Fed. Reg. at 59,581.

[10] Prop. Treas. Reg. §1.6045-1(a)(12).

[11] REG-1227893-19, 88 Fed. Reg. at 59,581.

[12] REG-1227893-19, 88 Fed. Reg. at 59,608.

[13] REG-1227893-19, 88 Fed. Reg. at 59,608.

[14] REG-1227893-19, 88 Fed. Reg. at 59,608. For a recent discussion of the use of stablecoins versus tokenized deposits, *see* Rodney Garratt & Hyun Song Shin, *Stablecoins versus tokenised deposits: implications for the singleness of money*, BIS Bulletin No 73 (Apr. 11, 2023).

The treatment of a digital asset as subject to the reporting rules is not meant to imply anything regarding the characterization of the asset for any other purposes.[15] In particular, no inference should be drawn from the classification of an asset as a digital asset under these rules in regards to its classification as a security, commodity, option, futures contract, or forward contract for any other purpose of the Code.[16]

> *Observation: Companies that would normally not consider themselves to be in the cryptocurrency or DeFi industry should review the application of these Proposed Regulations and consider providing comments if they are considering to incorporate distributed ledger technology into their businesses. Treasury has noted that the Proposed Regulations would not apply to the use of distributed ledger technology for ordinary commercial purposes (e.g., inventory tracking or order processing), but if the transactions give rise to sales or create new transferable assets, there might be a sale of a digital asset that is reportable under these rules.*

Definition of brokers

For periods after 31 December 2023, section 6045(c)(1) defines the term "broker" to include "a dealer, a barter exchange, any person who (for consideration) regularly acts as a middleman with respect to property or services, and any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person."[17] The last clause relating to digital asset brokers was added in 2021, and has been criticized by many as overbroad, arguably subjecting many persons, including miners and validators, to the requirement to report information that is not within their control. Legislative proposals to address this concern have been raised a number of times, most recently in the Keep Innovation in America Act[18] and the Lummis-Gillibrand Responsible Financial Innovation Act,[19] both of which would revise the definition to read as follows: "any person who (for consideration) stands ready in the ordinary course of a trade or business to effect sales of [digital] assets at the direction of their customers."

> *Observation: Treasury has attempted to address in the Proposed Regulations some of the concerns with the definition of "broker." But the rules are still quite broad and might apply to parties that may not realistically be in a position to comply.*

The existing regulations under section 6045 define a broker as "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."[20] The statute requires that a broker who provides the service of effectuating transfers of digital assets do so "for consideration." Treasury explained in the preamble to the Proposed Regulations that the requirement of "consideration" in the statute should be satisfied for any person that effects sales for others "in the ordinary course of a trade or business," and intends that the "trade or business" requirement will result in a more limited definition of broker than would apply under the "for consideration" alternative.[21]

The Proposed Regulations provide that a person is considered to "effect" a sale of digital assets if that person:

- acts as a principal that is a dealer in the sale of the digital assets;
- regularly offers to redeem and does redeem digital assets for which it was the issuer;

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[15] REG-1227893-19, 88 Fed. Reg. at 59,582.

[16] Prop. Treas. Reg. §1.6045-1(a)(19)(ii).

[17] Section 6045(c)(1)(D).

[18] H.R.1414, 118th Cong., 1st Sess. §2 (2023).

[19] S.2281, 118th Cong., 1st Sess. §802 (2023).

[20] Treas. Reg. §1.6045-1(a)(1). Under the Proposed Regulations, this includes "a person that regularly offers to redeem digital assets that were created or issued by that person." For purposes of the Proposed Regulations, "person" is defined in section 7701(a)(1) as "an individual, a trust, estate, partnership, association, company or corporation."

[21] REG-1227893-19, 88 Fed. Reg. at 59,587.

- acts as agent for a party in the sale, and the nature of the agency is such that the agent ordinarily would know the gross proceeds from the sale; or
- acts as a "digital asset middleman" for a party in the sale of digital assets.[22]

A person acting as a principal in the sale of digital assets is only considered to effect a sale for this purpose if acting as a dealer with respect to the sale.[23] Therefore, a merchant that accepts digital assets as payment for goods or services that are not digital assets is not a broker, unless the merchant is otherwise a dealer in digital assets.[24] Likewise, a person who creates and sells digital assets (such as artwork in the form of NFTs) is not a broker, unless otherwise acting as a dealer in digital assets.[25]

Observation: It is possible that one line of business might taint a taxpayer as a broker even though not every line of business would treat the taxpayer as a broker. Treasury has noted that even if a person's principal business does not meet the definition of a broker, less substantial lines of business that meet the definition could render the person to be a broker.

Digital asset middleman and facilitative services

A digital asset middleman is "any person who provides a *facilitative service* … with respect to a sale of digital assets wherein 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 from the sale."[26]

A facilitative service is any service that "directly or indirectly effectuates a sale of digital assets."[27] This includes providing any of the following: access to an automatically executing contract or protocol to a party selling digital assets; access to a digital asset trading platform; an automated market maker system; order matching services; market making functions; services to discover the most competitive buy and sell prices; or escrow-like services to ensure both parties to an exchange act in accordance with their obligations.[28]

Providing validation services as part of the consensus mechanism of a blockchain, whether that consensus is based on proof-of-work, proof-of-stake, or some other similar consensus mechanism, is not a facilitative service, but only if the miner or validator does not perform other functions or services in addition to validation services.[29] Similarly, selling hardware or software, the *sole* function of which is to permit persons to control private keys that are used to access on-chain digital assets is not a facilitative service.[30] A wallet that provides direct access to trading platforms from the wallet does not qualify for this exception.[31]

Even if a person provides a facilitative service, that person is not considered a digital asset middleman unless that 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 from the sale."[32] According to the Proposed Regulations, a person "ordinarily would know or be in a position to know" the identity of a party making a sale of digital assets if that person "maintains sufficient control or influence over the facilitative services provided to have the ability to set or change the terms under which its services are provided to request that the party making

[22] Prop. Treas. Reg. §1.6045-1(a)(10).

[23] REG-1227893-19, 88 Fed. Reg. at 59,587.

[24] Prop. Treas. Reg. §§1.6045-1(b)(2)(viii) and -1(b)(15).

[25] Prop. Treas. Reg. §1.6045-1(b)(20).

[26] Prop. Treas. Reg. §1.6045-1(a)(21)(i) (emphasis added).

[27] Prop. Treas. Reg. §1.6045-1(a)(21)(iii)(A).

[28] Prop. Treas. Reg. §1.6045-1(a)(21)(iii)(A).

[29] Prop. Treas. Reg. §§1.6045-1(a)(21)(iii)(A), -1(b)(2)(ix), and -1(b)(18).

[30] Prop. Treas. Reg. §§1.6045-1(a)(21)(iii)(A), -1(b)(2)(x), -1(b)(21),and -1(b)(23).

[31] Prop. Treas. Reg. §§1.6045-1(a)(21)(iii)(A), -1(b)(1)(xi), and -1(b)(22).

[32] Prop. Treas. Reg. §1.6045-1(a)(21)(i) (emphasis added).

the sale provide that party's name, address, and taxpayer identification number upon request."[33] Similarly, a person is in a position to know the nature of the transaction if that person "maintains sufficient control or influence over the facilitative services provided 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, including by reference to the consideration that the person receives or pursuant to the operations of or modifications to an automatically executing contract or protocol to which the person provides access."[34] The ability to change the fees charged for the facilitative services is considered sufficient control to be in a position to know the identity of the seller and the nature of the transaction.[35]

Digital asset payment processor

A person that handles payments for customers in the form of digital assets may be treated as a digital asset payment processor that is subject to the broker reporting requirements.[36] A digital assets payment processor is a person that in the ordinary course of its trade or business stands ready to effect certain payment processing transactions that are considered sales of digital assets, including the payment by a party of a digital asset to the digital asset payment processor in return for the payment by the digital asset payment processor of cash or a different digital asset to a second party.[37] A transfer of digital assets from one party to a second party (such as a vendor of goods or services) pursuant to a processor agreement between a payment processor and the second party is deemed for this purpose to be a payment of the digital asset to the payment processor in exchange for the payment of cash or a different digital asset to the second party.[38] A digital assets payment processor also includes a person that acts as a third party settlement organization (as defined in Treas. Reg. §1.6050W-1(c)(2)) or a payment card issuer facilitating payments to a merchant acquiring entity (as defined in Treas. Reg. §1.6050W-1(b)(2)) using one or more digital assets in settlement of a reportable payment transaction under Treas. Reg. §1.6050W-1(a)(2).[39]

The person using digital assets to make the payment is treated as a customer of the digital asset payment provider, thereby requiring the digital asset payment provider to collect and report the identity of the customer and the gross amount of the payment transaction. Treasury considered but rejected the idea of including a de minimis rule for transaction reporting by digital asset payment providers.[40] Because the digital asset payment provider may also have information reporting obligations under section 6050W with respect to the merchant receiving the payment, the Proposed Regulation contain rules to address this overlap, which we discuss below.

> *Observation: Traditional financial institutions, like banks, credit card companies, and payment processors likely will find themselves subject to these rules if they process payments denominated in digital assets.*

Real estate reporting person

Under the Proposed Regulations, a broker includes a real estate reporting person who would be required to make an information return with respect to a real estate transaction.[41] In case the buyer pays for real estate in digital assets, the reporting person must report the following information: name and number of units of the digital asset used to make the payment, the date and time of the

[33] Prop. Treas. Reg. §1.6045-1(a)(21)(ii)(A). This rule is similar to the standard applied by the Financial Action Task Force for determining whether a person involved in a decentralized application that provides financial services should be considered a "virtual asset service provider" that is subject to anti-money laundering and counter-terrorist financing rules. *See* REG-1227893-19, 88 Fed. Reg. at 59,586.

[34] Prop. Treas. Reg. §1.6045-1(a)(21)(ii)(B).

[35] Prop. Treas. Reg. §§1.6045-1(a)(21)(ii)(A) and (B); *see also* Prop. Treas. Reg. §§1.6045-1(b)(17), (19), and (22) for examples of transactions where a fee was charged for facilitative services.

[36] Prop. Treas. Reg. §1.6045-1(b)(1)(vii).

[37] Prop. Treas. Reg. §§1.6045-1(a)(9)(D) and -1(b)(12).

[38] Prop. Treas. Reg. §§1.6045-1(a)(22)(ii) and -1(b)(13).

[39] Prop. Treas. Reg. §§1.6045-1(a)(22)(B) and (C); *see also* Prop. Treas. Reg. §§1.6045-1(b)(14) and (16).

[40] REG-1227893-19, 88 Fed. Reg. at 59,590.

[41] Prop. Treas. Reg. §1.6045-1(a)(1). A real estate reporting person is the person responsible for closing, or in absence of such person, the mortgage lender, broker, or transferee. Treas. Reg. §1.6045-4(e).

payment, the transaction identification of the digital asset transfer,[42] and the digital asset address into which the digital assets are transferred.[43] The real estate reporting person is also required to report total gross proceeds from digital assets paid in the real estate transaction.[44] Finally, although the Proposed Regulations consider the existing backup withholding rules under section 3406 and its regulations to be broad enough to cover transactions in digital assets, Treasury has modified an exception available for real estate reporting persons such that sales of digital assets in return for real estate that are effected by brokers will be subject to backup withholding.[45]

Observation: The Proposed Regulations apply the broker definition to real estate transaction despite exceptions normally provided for sales of principal residences and sales by exempt real estate sellers such as corporations.

The sale of digital assets

The definition of "sale" has also been expanded in the Proposed Regulations to account for the variety of ways in which digital assets may be exchanged. A sale of a digital asset includes the disposition of any digital asset in exchange for cash or stored-value cards,[46] a different digital asset,[47] property of a type that is otherwise subject to reporting under section 6045,[48] of services of a broker.[49] A sale also includes the delivery of a digital asset pursuant to the settlement of a forward contract, option, regulated futures contract, any similar instrument, or any other executory contract that would be treated as a sale of a digital asset if the contract had not been executory.[50]

As noted in the preamble to the Proposed Regulations, there are a number of transactions that do not fall within the definition of a sale. For instance, the receipt of a new digital asset without disposing of something in exchange (e.g., the receipt of tokens in a hard fork or airdrop) is not a sale.[51] Likewise, the receipt of digital assets in exchange for the performance of services is not a sale.[52] Finally, a broker is not considered to effect a sale if the broker would not ordinarily know of be in a position to know that a transfer of digital assets is part of a sale transaction.[53]

The Proposed Regulations do not address whether reporting should be required for a loan of digital assets, the transfer of digital assets to or from a liquidity pool, or the wrapping or unwrapping of a digital asset.[54] Treasury has requested comments regarding the proper treatment of these transactions, and any other transactions not described in the Proposed Regulations.

[42] Prop. Treas. Reg. §1.6045-1(a)(26).

[43] Prop. Treas. Reg. §1.6045-1(a)(20).

[44] Prop. Treas. Reg. §1.6045-4(i).

[45] Prop. Treas. Reg. §31.3406(g)-2(e).

[46] Prop. Treas. Reg. §1.6045-1(a)(9)(ii)(A)(1).

[47] Prop. Treas. Reg. §1.6045-1(a)(9)(ii)(A)(2).

[48] Prop. Treas. Reg. §1.6045-1(a)(9)(ii)(B).

[49] Prop. Treas. Reg. §1.6045-1(a)(9)(ii)(C).

[50] Prop. Treas. Reg. §1.6045-1(a)(9)(ii)(A)(3).

[51] REG-1227893-19, 88 Fed. Reg. at 59,593.

[52] REG-1227893-19, 88 Fed. Reg. at 59,593.

[53] REG-1227893-19, 88 Fed. Reg. at 59,591. A digital asset payment processor would typically know whether a transfer was part of a sale transaction, and therefore will generally be treated as effecting a sale. *See* Treas. Reg. §1.6045-1(a)(9)(ii)(D).

[54] REG-1227893-19, 88 Fed. Reg. at 59,591.

Information to be reported

For each digital asset sale, a broker is required to report:

- the name, address, and taxpayer identification number of the customer;
- the name and number of unites of the digital asset sold;
- the sale date and time;
- the gross proceeds of the sale;
- the transaction ID associated with the sale;
- the digital asset address (e.g., the wallet address) from which the digital asset was transferred;
- whether consideration was cash, stored-value cards, services, or other property; and
- any other information required by the form or instructions.[55]

Observation: The information required to be provided under the Proposed Regulations may raise significant data privacy concerns, as personally identifiable information will be linked with a specific wallet address, the entire history of which is publicly visible on chain.

In the case of a sale of a digital asset that was previously transferred to an account at the broker and is held by the broker in a hosted wallet, the broker must also report the number of units transferred in by the customer, the date and time of the transfer in, the transaction ID of the transfer in, and the digital asset address from which the digital asset was transferred.[56]

Observation: It is not particularly clear whether the requirement to report information on transfers into an account or hosted wallet applies to information on transfers that took place before the effective date of the Proposed Regulations. If so, then brokers that have not compiled this information for past transfers may be required to reconstruct this information from data on the relevant blockchain ledger.

The IRS will post drafts of the forms required to be submitted on its website, when such forms are available. Finally, the Proposed Regulations modify rules under section 6721 (failure to file an information return) and section 6722 (failure to furnish a payee statement) to account for information statements required by the Proposed Regulations.

Rules for non-US digital asset brokers and exempt foreign persons

The existing reporting rules for securities brokers exclude from the definition of a broker a non-US payor or middleman, except with respect to sales it effects at an office within the United States.[57] The logic behind the existing rules is that a broker is assumed to effect sales through an office at a physical location and to conduct business with customers in person. Treasury observed in the preamble to the Proposed Regulations that digital asset brokers likely effect sales and interact with customers entirely online, and therefore has adopted a different approach for digital asset brokers.[58]

The Proposed Regulations generally deem sales to be effected either within or outside of the United States based on whether the digital asset broker is considered a US digital asset broker, a CFC digital asset broker, or a non-US digital asset broker.[59] Sales by a

[55] Prop. Treas. Reg. §1.6045-1(d)(2)(i)(B).

[56] Prop. Treas. Reg. §1.6045-1(d)(2)(i)(B).

[57] Treas. Reg. §6045-1(a)(1).

[58] REG-1227893-19, 88 Fed. Reg. at 59,599.

[59] Prop. Treas. Reg. §1.6045-1(g)(4). A US digital asset broker is a US payor or middleman (as defined in Treas. Reg. §1.6049-5(c)(5)), other than a controlled foreign corporation, that effects sales of digital assets on behalf of others. A CFC digital asset broker is a controlled foreign corporation

US digital asset broker are all considered to be effected at an office in the United States.[60] Sales by a CFC digital asset broker or a non-US digital asset broker are generally considered to be effected at an office outside the United States.[61] A sale by a non-US digital asset broker will be treated as effected at an office in the United States if the broker collects documentation or has account information that indicates that the customer has connections to the United States or may be a US person (US indicia).[62] The consequence of these rules is that both US digital asset brokers and CFC digital asset brokers will be treated as brokers for all sales that they effect for customers, while a non-US digital asset broker will only be treated as a broker with respect to sales that are deemed to be effected at an office in the United States because the non-US digital asset broker has US indicia with respect to its customer.

Under the existing regulations, a broker is not required to report sales effected for a customer that is either an exempt recipient or an exempt foreign person.[63] The Proposed Regulations provide specific rules for determining when a customer of a digital asset broker is an exempt foreign person. To treat an individual customer as an exempt foreign person, a US digital asset broker must obtain a valid withholding certificate, such as a Form W-8BEN.[64] In contrast, a CFC digital asset broker is permitted to rely on either a withholding certificate or documentary evidence, such as a foreign driver's license or other government identification, in support of the customer's status as an exempt foreign person.[65] A non-US digital asset broker that has US indicia for a customer can generally treat that customer as an exempt foreign person if the broker obtains either a withholding certificate or documentary evidence plus a written statement from the customer that they are not a US person and are not acting for a US person.[66] In the absence of valid documentation, a US digital asset broker must treat an individual customer as a US person, while a CFC digital asset broker or non-US digital asset broker is only required to treat an individual customer as a US person if the broker has US indicia for the customer.[67]

The rules for CFC digital asset brokers and non-US digital asset brokers are modified if they are registered with FinCEN as a "money service business" under the Bank Secrecy Act.[68] If a CFC digital asset broker or a non-US digital asset broker acts as a money service business with respect to a sale of digital assets, then the broker will be treated as a US digital asset broker for purposes of determining the place where the sale is effected and whether a customer qualifies as an exempt foreign person.[69] Treasury is considering whether to apply a similar rule to CFC digital asset brokers and non-US digital asset brokers that are regulated by other US regulators besides FinCEN.[70]

(as defined in Treas. Reg. §1.6049-5(c)(5)(i)(C)) that effects sales of digital assets on behalf of others. A non-US digital asset broker is a non-US payor or middleman (as defined in Treas. Reg. § 1.6049-5(c)(5)) that effects sales of digital assets on behalf of others.

[60] Prop. Treas. Reg. §1.6045-1(g)(4)(ii)(A).

[61] Prop. Treas. Reg. §§1.6045-1(g)(4)(iii)(A) and -1(g)(4)(iv)(A).

[62] Prop. Treas. Reg. §1.6045-1(g)(4)(iv)(B). The US indicia include: (1) the customer communicates with the broker using a device with an IP address in the United States; (2) the broker's records for the customer reflect a US address, phone number, or classification of the customer as a US person; (3) the customer uses an account at a bank or other financial institution in the United States to transfer funds to or from the broker; (4) the customer transferred digital assets to or from another digital asset broker that the broker knows or has reason to know is organized in the United States; and (5) the broker has an unambiguous indication that the customer was born in the United States.

[63] Treas. Reg. § 1.6045-1(c)(3) and (g)(1). Generally speaking, the term "exempt recipient" refers to certain corporations, tax exempt organizations, financial institutions, and governments or political subdivisions. Treas. Reg. § 1.6045-1(c)(3)(i)(B).

[64] Prop. Treas. Reg. §1.6045-1(g)(4)(ii)(B).

[65] Prop. Treas. Reg. §1.6045-1(g)(4)(iii)(B). For this purpose, "documentary evidence" is described in Treas. Reg. §1.1471-3(c)(5)(i).

[66] Prop. Treas. Reg. §1.6045-1(g)(4)(iv)(D)(1). If the broker has an unambiguous indication that the customer was born in the United States, however, then the customer can only be treated as an exempt foreign person if the broker obtains documentary evidence of citizenship in a country other than the United States, plus either a copy of the customer's Certificate of Loss of Nationality of the United States, or a withholding certificate and a written statement of the customer's renunciation of US citizenship or failure to obtain US citizenship at birth. Prop. Treas. Reg. §1.6045-1(g)(4)(iv)(D)(2).

[67] Prop. Treas. Reg. §1.6045-1(g)(4)(vi)(A)(2).

[68] A broker is considered to conduct a money service business if it is registered as such with the Department of the Treasury under 31 CFR 1022.380. Prop. Treas. Reg. §1.6045-1(g)(4)(i)(D).

[69] Prop. Treas. Reg. §1.6045-1(g)(4)(iv).

[70] REG-1227893-19, 88 Fed. Reg. at 59,599.

Treasury notes in the preamble to the Proposed Regulations that the regime for digital asset brokers would need to be modified if the United States were to implement the Crypto-Asset Reporting Framework (CARF) that was developed by the OECD.[71] Because CARF would likely result in an automatic exchange of information between tax administrations, US digital asset brokers might be required to collect information on transactions with customers that would otherwise be treated as exempt foreign persons under the current rules, while non-US digital asset brokers might be relieved of the obligation to report under section 6045 on sales effected by US customers.

Effective dates

The Proposed Regulations require brokers to report gross proceeds from sales of digital assets effected on or after 1 January 2025. Until regulations are issued with respect to transfer statements under section 6045A, reporting of adjusted basis and character of gain or loss on sales of digital assets is only required for sales effected on after 1 January 2026 by brokers that provide hosted wallet services, and only with respect to digital assets acquired in a customer's account on or after 1 January 2023.[72] Voluntary reporting of gross proceeds, adjusted basis and/or the character of any gain or loss before the relevant effective date is permitted, and any such reporting of information that is incorrect will not be subject to penalties under sections 6721 or 6722.[73]

Coordination of Section 6045 Reporting with Other Reporting Requirements

Priority rules for reporting requirements

A broker of digital assets may also be a barter exchange or a payment settlement entity, which are subject to different reporting requirements. The Proposed Regulations provide rules of priority among these reporting requirements so that brokers may avoid duplicate reporting.[74]

A digital asset exchange transaction, in which digital assets are exchanged for goods (including different digital assets) or services, may qualify as more than one of the following:

(1) a sale of digital assets effected by a broker;

(2) a "reportable payment transaction" settled by a payment settlement entity; and

(3) an exchange through a barter exchange.

A reportable payment transaction is any transaction in which a payment card is accepted as payment and any third-party network transaction for the provision of goods or services that is settled through a third-party payment network.[75] For example, an online platform that connects sellers and buyers of services, and that collects payments from buyers and remits the payments to sellers, may qualify as a payment settlement entity settling reportable payment transactions.[76] Each type of transaction is subject to its own reporting rules: Prop. Treas. Reg. §§ 1.6045-1(c) and (d) (reporting by brokers); Treas. Reg. §§ 1.6045-1(e) and (f) (reporting by barter exchanges); and Treas. Reg. § 1.6050W-1(a)(1) (reporting by payment settlement entities).[77]

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[71] REG-1227893-19, 88 Fed. Reg. at 59,598.

[72] Prop. Treas. Reg. §1.6045-1(a)(15)(i)(J).

[73] Prop. Treas. Reg. §1.6045-1(d)(2)(iii)(B).

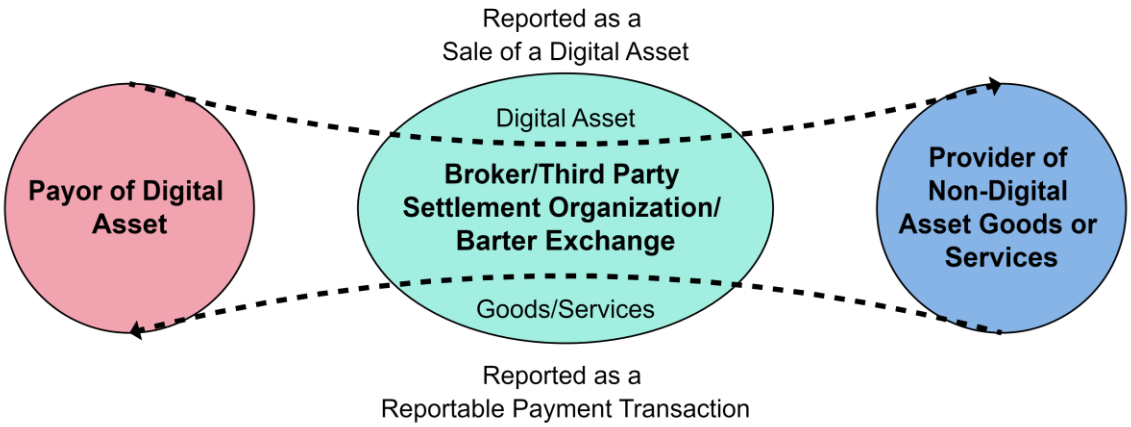
[74] *See* Prop. Treas. Reg. §1.6045-1(e)(2)(iii) and §1.6050W-1(c)(5).

[75] *See* section 6050W for definitions and details.

[76] *See, e.g.*, PLR 201836008 (Sep. 7, 2018).

[77] Section 6041 also contains reporting requirements that apply to any person that makes payments of $600 or more that are deemed to be fixed or determinable income, and also requires the person to furnish statements to the payee, setting forth the amount of gains, profits, and income resulting from the payment. However, section 6041 does not apply if the payment is in consideration for a capital asset and the payor has no way of ascertaining the payee's basis in the asset. Section 6041 also does not apply to a broker's payments to customers. To the extent that a payment is reportable under both sections 6041 and 6050W, the payment must be reported under section 6050W.

The Proposed Regulations provide priority rules specifying which reporting requirements apply in case of overlap. In short, the reporting rules for (1) have priority over both (2) and (3), and the reporting rules for (2) have priority over (3). If, for example, a digital asset is exchanged for goods other than digital assets or for services through a broker that is also a barter exchange, and the digital asset exchange is a reportable payment transaction, then, with respect to the party disposing of the digital asset, the exchange is reported as a sale of a digital asset under Prop. Treas. Reg. § 1.6045-1(c), and with respect to the party disposing of the property or services, the exchange is reported as a reportable payment transaction under Treas. Reg. § 1.6050W-1(a)(1), as illustrated below.



Reporting under sections 6045A and 6045B

A broker of digital assets is also subject to reporting requirements under sections 6045A and 6045B, but the Proposed Regulations have delayed those reporting requirements until Treasury issues further guidance. Section 6045A(a) requires brokers to report transfers of covered securities to other brokers, and section 6045A(d) requires brokers to report transfers of digital assets that are covered securities to an account maintained by a person that the broker knows or has reason to know is not broker, provided the transfer is not a sale or exchange executed by the broker. Section 6045B requires issuers of specified securities to report any organizational action that affects the basis of the issuer's specified securities (e.g., stock splits, mergers, acquisitions, stock distributions). Digital assets came within the scope of sections 6045A(a) and 6045B when the Infrastructure Investment and Jobs Act amended section 6045(g)(3) to treat digital assets as specified securities.

The Proposed Regulations do not provide guidance on the reporting requirements under sections 6045A and B with respect to digital assets, and have delayed those reporting requirements until Treasury issues further guidance. The Proposed Regulations expressly provide that transfer statement reporting under section 6045A(a) and issuer reporting under section 6045B are not required for specified securities that are also digital assets. Although the Proposed Regulations do not expressly provide that broker information reporting under section 6045A(d) is also not yet required, this appears to be the implication because the information return is to be "in such form as determined by the Secretary, showing the information otherwise required to be furnished with respect to transfers subject to subsection [6045A](a),"[78] i.e., "such information as the Secretary may by regulations prescribe,"[79] which the Secretary has not yet prescribed with respect to digital assets.

Determining the Amount Realized and Cost Basis in Sales of Digital Assets

Amount realized under section 1001 on a sale of digital assets

The amount realized on the sale or other disposition of digital assets is generally equal to the excess of the sum of (i) the cash received; (ii) the fair market value of any property received (including digital assets and the issue price of any debt instrument), and

[78] Section 6045A(d).

[79] Section 6045A(a).

(iii) the fair market value of any services received, over the digital asset transaction costs allocable to the sale.[80] If the fair market value of the property or services received in exchange for the digital assets cannot be determined with reasonable accuracy, then the fair market value of such property or services is determined by reference to the fair market value of the transferred digital assets.[81]

The Proposed Regulations define digital asset transaction cost as the amount paid, either in cash or property, to effect the disposition or acquisition of a digital asset and includes transaction fees, transfer taxes, and any other commissions.[82] If digital assets are used to pay digital asset transaction costs, such use constitutes the disposition of such digital assets in exchange for services,[83] and the fair market value of such transaction services is included in the amount realized.[84] In the case of an exchange of digital assets for other digital assets, one-half of the total digital asset transaction costs incurred by the seller are allocable to the disposition of the transferred digital assets (and any allocations made by the parties are ignored).[85] Otherwise, the digital asset transaction costs allocable to the sale or disposition of digital assets equals the total digital asset transaction costs incurred by the seller of the digital asset.[86]

Basis under section 1012 of acquired digital assets

The basis of digital assets acquired in an exchange is generally equal to the cost of the digital assets at the date and time of the exchange, plus any allocable digital asset transaction costs.[87] For digital assets purchased for cash, the basis of the acquired digital assets equals the amount of cash paid, plus any allocable digital asset transaction costs.[88] For digital assets acquired in exchange for services or property other than digital assets, the basis of the acquired digital assets generally equals the fair market value of the services or property exchanged for such assets, plus any allocable digital asset transaction costs.[89] For digital assets acquired in exchange for other digital assets differing materially in kind or in extent, the basis of the acquired digital assets generally equals the fair market value of the transferred digital assets, plus half of the total allocable digital asset transaction costs.[90]

Identification rules

If a taxpayer sells less than all units of the same digital assets held within a single unhosted wallet, the Proposed Regulations provide that the unit disposed of for purposes of determining basis and holding period are determined by specific identification of units of the particular digital asset in the wallet or account that the taxpayer intended to sell. If not specified, for example on books and records with reference to an identifier such as purchase date or time, the order is determined from the earliest purchase date of the unit (the dates the units transferred to the taxpayer's wallet are disregarded). For multiple units of a type of digital asset left in custody of a broker, the taxpayer can make an adequate identification of the units sold by specifying to the broker the particular units to be sold by reference to any identifier that the broker designates as being sufficient to determine basis and holding period. If the taxpayer does not provide the broker with such information, the units disposed of are determined in order of time from earliest unit purchased within or transferred to taxpayer's account with the broker. Treasury anticipates that further transfer statement reporting under section 6045A will revise these rules. Finally, specifically identifying the units of a particular digital asset sold is not a method of accounting and a change in method is not a change in method of accounting.

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[80] Prop. Treas. Reg. §1.1001-7(b)(1)(i).

[81] Prop. Treas. Reg. §1.1001-7(b)(4).

[82] Prop. Treas. Reg. §1.1001-7(b)(2)(i).

[83] Prop. Treas. Reg. §1.1001-7(b)(1)(ii).

[84] Prop. Treas. Reg. §§1.1001-7(b)(1)(iii) and -7(b)(5)(iv).

[85] Prop. Treas. Reg. §1.1001-7(b)(2)(ii)(B).

[86] Prop. Treas. Reg. §1.1001-7(b)(2)(ii)(A).

[87] Prop. Treas. Reg. §1.1012-1(h)(1).

[88] Prop. Treas. Reg. §1.1012-1(h)(1)(i).

[89] Prop. Treas. Reg. §§1.1012-1(h)(1)(ii) and (iii).

[90] Prop. Treas. Reg. §1.1012-1(h)(1)(iv).

Effective date

The proposed regulations under sections 1001 and 1012 regarding the determination of gain or loss and cost basis for digital assets are proposed to apply to taxable years on or after January 1 of the calendar year immediately following the date of publication of final regulations in the Federal Register.[91]

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[91] REG-1227893-19, 88 Fed. Reg. at 59,616.