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Alert | Tax/Blockchain & Digital Assets

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Treasury and IRS Issue New Proposed Regulations on Digital Assets

On Aug. 25, 2023, the Internal Revenue Service (IRS) and the Treasury Department issued proposed regulations (the Proposed Regulations) regarding the sales or exchanges of digital assets, including cryptocurrency. The Proposed Regulations relate to both information reporting requirements and the determination of amount realized, basis, and backup withholding.

Background

Prior to the issuance of the Proposed Regulations, the IRS issued limited and infrequent guidance on the tax treatment of digital assets. The IRS first provided guidance on digital assets in 2014, when it issued Notice 2014-21, which stated that cryptocurrency would be treated as property for U.S. federal income tax purposes. In 2019, the IRS released Revenue Ruling 2019-24, which addressed questions related to the tax treatment of hard forks. In July 2023, the IRS clarified the taxation of staking cryptocurrency rewards in Revenue Ruling 2013-14. Since 2019 the IRS website has also listed some Frequently Asked Questions on cryptocurrency transactions.

Taxpayers have been waiting for these Proposed Regulations since Congress passed the Infrastructure Investment and Jobs Act (Public Law 117-58) (the Infrastructure Act) in 2021. Section 80603 of the Infrastructure Act introduced modifications to the broker reporting rules outlined in section 6045 of the Internal Revenue Code (the Code) in connection with digital assets. These changes broadened the

application of the reporting requirements with respect to all persons who effectuate transfers of digital assets.

The Proposed Regulations detail the obligations of brokers who facilitate the exchange of digital assets for cash, broker services, or specific types of property, including various digital assets, securities, and real estate. The Proposed Regulations would also broaden the definition of the term "broker" to include digital asset trading platforms, payment processors, wallet providers, and those who redeem digital assets they created. Further, the Proposed Regulations would also require the reporting of real estate transactions involving digital assets.

The Proposed Regulations outline specific rules for reporting exchanges of digital assets for goods or services, with barter exchange transactions generally not falling under their purview. Additionally, the Proposed Regulations offer guidance on determining the realized amount and basis for digital assets. It is important to note that these regulations would pertain exclusively to federal tax laws and do not imply any changes to other legal frameworks, such as federal securities laws or the Commodity Exchange Act.

The Proposed Regulations are structured to follow the existing rules for broker information reporting but have been tailored to accommodate the distinctive features of digital assets, considering amendments made by the Infrastructure Act.

Specific Provisions of the Proposed Regulations

Expansion of Existing Information Reporting Rules to Digital Assets

i. Application and Definition of Digital Assets: The Proposed Regulations would define "digital assets" consistent with the Infrastructure Act, describing them as digital representations of value recorded on a secure distributed ledger or similar technology including a centralized internal ledger of a broker, but excluding fiat currency stored in any digital form.

   Under existing Treas. Reg. § 1.6045-1(a)(9), brokers are required to report sales on behalf of customers only for certain property types like securities and commodities. The Proposed Regulations would extend reporting requirements to include certain digital asset dispositions that occur in exchange for cash, different digital assets, stored-value cards, broker services, or other property types specified under existing Code Section 6045 regulations.

   GT Observation: The Proposed Regulations are expansive. As the digital asset landscape is continuously evolving, these reporting requirements could apply to new types of digital assets that may emerge in the future.

ii. Certain Exclusions from Reporting: The Proposed Regulations would call for broker reporting for all forms of digital assets, including stable coins and non-fungible tokens (NFTs), reflecting the comprehensive nature of the Infrastructure Act's definition. However, certain digital assets would not be subject to the Proposed Regulations, including digital assets that exist only in a closed ecosystem (e.g., tokens used for playing video games that cannot be sold or exchanged outside the video game). Further, the Proposed Regulations would not apply to using blockchain technology for routine business tasks, such as tracking inventory or processing orders, which usually do not involve any sale or exchange of digital assets described in the Proposed Regulations.

   GT Observation: While the Treasury Department and the IRS are aware of the financial industry's exploration of distributed ledger technology for securities transactions, the Proposed

Regulations would not provide any exemption from reporting for digital asset transactions that solely facilitate order processing, clearing, or settlement.

iii. Coordination with Existing Rules applicable to Securities, Commodities and Real Estate: To avoid duplication and ensure consistency, the Proposed Regulations would establish coordination rules to clarify whether a transaction should be reported under the existing rules for securities, commodities, and real estate, or under the proposed digital asset regulations. Under this proposed coordination rule, a sale of an asset that qualifies both as a security and a digital asset should be reported solely as a sale of a digital asset. In addition, a sale of an asset that qualifies both as a commodity and a digital asset would be reported solely as a sale of a digital asset and not as a sale of a commodity. However, additional reporting requirement would be applied if a sale of digital assets also constituted a sale of security or a sale of a commodity.

Further, distributed ledger technology use in real estate transactions might create digital representation of real estate. To prevent duplicate reporting, the Proposed Regulations would provide that when a digital asset qualifies as reportable real estate, brokers would only report it as real estate, not a digital asset.

GT Observation: The Proposed Regulations cannot be used as a basis for determining whether a digital asset qualifies as either a security or a commodity for other Code purposes, like the trading safe harbor rules found in Section 864(b)(2) of the Code. Accordingly, a separate analysis would be required to determine whether a digital asset is a security or a commodity for all other tax purposes.

iv. Reporting for Financial Contracts: The Proposed Regulations would expand the reporting rules for financial contracts related to digital assets, including options, futures, and forward contracts. Reporting treatment would depend on various factors, including whether the option is a Section 1256 contract (regarding any regulated futures contract, foreign currency contract, non-equity option or dealer equity option), whether the transaction involves the delivery of the underlying property, and whether the option itself is a digital asset or not. For Section 1256 contracts, existing rules would apply. Regulated futures contracts would continue to be reported under existing regulations. Forward contracts subject to reporting would include those requiring digital asset delivery, with reporting depending on the nature of the forward contract and the underlying asset.

Definition of Brokers Required to Report

Prior to the Infrastructure Act, a broker was defined as someone who acted as a middleman in property or service transactions. The Infrastructure Act added to the definition of a "broker" under Section 6045 anyone who, for consideration, regularly provides services facilitating the transfer of digital assets on behalf of others.

The Proposed Regulations would maintain the existing definition of a broker as someone ready to "effect" sales made by others. However, the definition of "effect" would be revised to include anyone providing services that facilitate sales of digital assets and who would typically know or be in a position to know the identity of the parties involved. This change is meant to ensure that those who can obtain relevant information for tax compliance purposes are considered brokers. The Proposed Regulations would apply to a wide range of platforms, regardless of their organizational structure and encompass individuals, legal entities, and unincorporated groups or organizations engaged in business or financial activities.

Specifically, the Proposed Regulations provide examples to illustrate who qualifies as a broker in the context of digital asset transactions:

i. Digital Asset Brokers: The Proposed Regulations would expand the definition of a broker to include businesses that facilitate the sale of digital assets, whether they operate physically (like kiosks) or online (trading platforms). This would include platforms that hold custody of assets of its customers or exert influence over non-custodial trading platforms. Operators may be treated as brokers, regardless of whether they are individuals, legal entities, or decentralized autonomous organizations (DAOs).

ii. Digital Asset Hosted Wallet Providers: The Proposed Regulations would include digital-asset-hosted wallet providers, similar to securities custodians or agents who handle digital asset sales and possess related information.

iii. Digital Asset Payment Processors: Payment processors that accept digital assets and convert them to other assets or cash for merchants would be required to provide information on these transactions under the Proposed Regulations. This would include transactions where the customer pays in digital assets, and the payment processor converts them into cash for the merchant.

iv. Other Brokers: The definition of a broker would be expanded to include those who regularly offer to redeem digital assets issued by them, like stablecoin issuers. The Proposed Regulations would ensure reporting on redemptions even if they aren't conducted regularly.

v. Real Estate Reporting: Real estate reporting persons (such as title companies or law firms acting as closing agents) would be considered brokers when digital assets are used as consideration in real estate transactions (whether the purchaser of the real estate uses digital assets to pay for the purchase price, or the seller is paid with digital assets), requiring them to report on these transactions.

The Proposed Regulations would also specifically exclude from the definition of a broker certain types of services because the persons engaged in those services may not be in a position to know the identity of the parties involved in a transaction:

i. Distributed Ledger Validation Services: This would exempt miners and stakes, as long as they do not provide other functions or services that may qualify them as a broker.

ii. Sellers of Hardware or Licensing Software: The exclusion from the definition of a broker would only apply when the sole function of the hardware or software is to permit persons to control private keys used for accessing digital assets on a distributed ledger.

iii. Retailers: Retailers that accept digital assets from customers as payment would not be considered "effecting" the sale of digital assets if the retailers are not otherwise a dealer of digital assets.

iv. NFT Artists: The creation and selling of NFTs that represent interest in the artist's work would not be considered "effecting" the sale of digital assets if the artists are not otherwise a dealer of digital assets. This exclusion would apply even if an artist regularly sells NFTs directly or through digital asset brokers. However, galleries representing an NFT artist would be classified as brokers required to report NFT sales.

GT Observations:

The Proposed Regulations would compel decentralized exchanges to collect information from their customers, even if they do not usually solicit comprehensive customer data or have a policy against doing so. This is because the Proposed Regulations consider the ability to modify the operation of a platform to obtain customer information as being in a position to know the identity of the parties involved in a transaction. The requirement for such exchanges to obtain this information from their customers and report it to the IRS is the central core of the enforcement goal requiring digital asset brokers to report transactions.

Unlike reporting requirements that may apply to digital asset payment processors under Code Section 6050W, the Proposed Regulations do not include a de minimis rule for reporting merchant transactions. Consequently, these information reporting rules would apply to all applicable digital product sales, no matter the value of the digital product sold.

Types of Digital Asset Sales Subject to Reporting

As digital assets are unique in that they can be exchanged for various types of assets, including other digital assets, cash, services, or property, to ensure comprehensive reporting of taxable exchanges, the Proposed Regulations would broaden the definition of a "sale" subject to reporting. Specifically, "sale" would include the following:

- The exchange of a digital asset for cash, stored-value cards (which encompass gift cards), or a different digital asset.
- Transactions involving brokers and real estate transactions where digital assets are used as consideration.
- Transactions where customers exchange digital assets for services offered by brokers.
- Transactions where customers pay digital assets to payment processors in exchange for different digital assets or cash.
- Payments made by customers to payment card issuers using digital assets.
- Executory contracts involving the future delivery of digital assets.

However, the Proposed Regulations would exclude specific transactions from the definition of a sale, such as hard fork transactions, airdrops, and transactions where digital assets are received for performing services. The Proposed Regulations acknowledge that these regulations may not cover all digital asset transactions and request comments on potential revisions to address other types of transactions not explicitly covered.

Information to Be Reported for Digital Asset Sales

The information that would be required to be reported under the Proposed Regulations closely resembles reporting for traditional securities on IRS Form 1099-B and includes details like customer information, digital asset specifics, sale date, and amount of gross proceeds.

Importantly, brokers would also need to report transaction IDs and digital asset addresses for digital asset previously transferred into a broker hosted wallet ("transferred-in digital asset") to aid in verification. As this reporting and tracking requirement could be onerous for brokers, the Treasury Department and the

IRS are seeking feedback on potentially less stringent alternatives, such as setting an annual sales threshold. In addition, brokers would also need to report whether the consideration received was cash, a different digital asset, other property, or services.

Furthermore, the Proposed Regulations would establish a uniform time standard, Coordinated Universal Time (UTC), for transaction timestamps. However, The Treasury Department and the IRS are seeking input on using a 12-hour or 24-hour clock and flexibility for transactions involving different time zones.

Determination of Gross Proceeds for Digital Asset Sales

The Proposed Regulations would align the computation of gross proceeds in a sale transaction with those for computing the amount realized in transactions involving digital assets. Thus, gross proceeds are defined as the sum of the total payment in U.S. dollars, fair market value of received property, and fair market value of services, minus allocable digital asset transaction costs. The fair market value in exchange transactions involving digital assets should be measured at the transaction's date and time. For services or property received, brokers would be required to use a reasonable valuation method based on contemporaneous evidence. However, for services linked to digital asset transaction costs, brokers would need to use the fair market value of the digital assets used to pay for these costs.

For purposes of determining the digital asset transaction costs, a single transaction fee that brokers generally charge for digital asset exchanges would be allocated to the disposition of digital assets. However, for exchanges involving materially different digital assets, the cost would be equally allocated to the disposition of the transferred asset and the acquisition of the received asset.

GT Observation: When receiving digital assets that are not regularly traded on established exchanges for services, determining the fair market value might be difficult.

Effective Date

The Proposed Regulations would apply to sales and exchanges of digital assets on or after Jan. 1, 2025. However, digital asset brokers would only be required to report the adjusted basis and the character of any gain or loss with respect to sales on or after Jan. 1, 2026. Although basis reporting would not be required until Jan. 1, 2026, the basis information must be provided for digital assets acquired on or after Jan. 1, 2023. The Proposed Regulations provide time to allow digital asset brokers to create and implement information reporting requirement systems to comply with the reporting requirement.

Method For Identifying Units of a Digital Assets

The Proposed Regulations provide rules for identifying which units of a digital asset are sold, disposed of, or transferred when not all units are involved:

- Specific identification is preferred, where units are identified at the time of the sale.
- For unhosted wallets, units are determined in order of time if specific identification is not done.
- For digital assets held by brokers, the taxpayer can specify the units (no later than the date and time of sale, disposition, or transfer) that are treated as sold, disposed of, or transferred.
- If no specific identification is provided, units are determined based on the earliest units purchased within the account.

Thus, a taxpayer may specifically identify the units of a particular digital asset sold or disposed of through various methods including by the earliest acquired, the latest acquired, the highest basis, or by documenting the specific unit's unique digital identifier, such as a private key, public key, and address, or by records showing the transaction information for all units of a specific digital asset held in a single account, wallet or address. The Proposed Regulations clarify that a taxpayer's method of specifically identifying units of a particular digital asset sold or disposed of is not a method of accounting, and therefore, Section 446 and 481 of the code do not apply.

GT Observation: This is a change from an IRS position previously posted in response to FAQ 41 on the IRS website. In that previous response the IRS stated that unless units of a digital asset were documented by the specific unit's unique digital identifier, units of digital assets were deemed to be sold in chronological order from the earliest purchased or acquired. The methods of identifying units of particular digital assets allowed under the Proposed Regulations would allow taxpayer flexibility when reporting their digital asset transactions, since it would allow the taxpayer to identify digital assets being sold that have a higher basis, in order to reduce the taxable gain recognized on the sale.

Items Not Covered by the Proposed Regulations:

Although the Infrastructure Act also amended Code Section 6045A, which generally requires the furnishing of an information statement by a broker who transfers covered securities to another broker, to apply to digital assets, the Proposed Regulations do not relate to Section 6045A. Rather, the Treasury Department and the IRS will focus on implementing reporting requirements for digital assets under Section 6045A(a) at a later date.

Determination of the Amount Realized and Basis in Purchased Digital Assets

i. Amount Realized: Under the Proposed Regulations, § 1.1001–7(b)(1)(i) outlines the general rule for determining the amount realized when selling or disposing of digital assets, which is the sum of the cash received, fair market value of any property received (including digital assets), and fair market value of any services received, minus digital asset transaction costs. Digital asset transaction costs are generally the expenses paid in cash or property (including digital assets) to facilitate the acquisition or disposition of digital assets.

   The Proposed Regulations clarify that when digital assets are used to pay transaction costs, it is considered a disposition for services. The rules apply differently depending on whether cash, services, digital assets, or other property are received in exchange for digital assets. There are also special rules for calculating the amount attributable to debt instruments issued for digital assets, which are based on the current rules under Treas. Reg. § 1.1012-1(g) related to the issue price of the debt instrument.

   Notably, the Proposed Regulations clarify that certain transfers of digital assets without an actual sale or exchange (e.g., transfer from an unhosted wallet to a hosted wallet) can trigger a taxable event resulting in a gain or loss if such a transfer incurs a fee paid in digital assets.

ii. Basis: The Proposed Regulations provide that the basis of digital assets is typically determined by its cost at the time of acquisition. In exchanges of digital assets, both the amount received for the transferred digital assets and the basis of the digital assets received are generally determined based on the fair market value of the digital assets received in the exchange and any allocable digital assets transactions costs, as discussed above.

The Proposed Regulations further provide special rules based on how digital assets are acquired. Thus, separate rules apply for basis determination of digital assets that are received in exchange for the performance of services, digital assets acquired in exchange for the issuance of a debt instrument, or digital assets received in a transfer, which is in part a sale and in part a gift.

The Proposed Regulations also provide how transaction costs for digital assets are allocated. In most cases, such costs are fully allocated to the received digital assets. However, in exchanges involving materially different digital assets, only half of the transaction costs are allocated to the received digital assets. Additionally, the Proposed Regulations outline how to determine the cost of digital assets received in specific exchanges, either based on their fair market value or by referencing the property transferred if fair market value cannot be accurately determined.

These regulations, stemming from the Infrastructure Act, address a wide range of aspects related to the taxation and reporting of digital asset transactions, representing a pivotal step in the continuous development of regulatory standards for digital assets in the United States. As these Proposed Regulations set the stage for a more transparent and accountable digital asset ecosystem in the years to come, taxpayers, brokers, and industry stakeholders should closely monitor developments in this space. It is important to note that Proposed Regulations are very broad, and will have significant ramifications to many segments of the cryptocurrency and NFT industries. Interested stakeholders who would like to provide comments on the Proposed Regulations must do so by Oct. 30, 2023. A public hearing has been scheduled for Nov. 7, 2023, at 10 a.m. EST.

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