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IRS Issues Proposed Regulations Relating to Digital Asset Transactions



The U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) recently released proposed regulations (REG-122793-19) pertaining to information reporting and backup withholding, as well as basis and amount realized determinations for certain transactions involving digital assets.

Recognizing the evolving landscape of digital assets, including cryptocurrencies and other blockchain-based tokens, Treasury and the IRS intend for these regulations (when finalized) to enhance tax compliance in the realm of digital asset transactions. These proposed regulations mark the initial phase of what will be a multiphase transformation in broker reporting for digital assets.

The primary focus of the proposed regulations is the extension of existing reporting requirements under Section 6045 of the Internal Revenue Code to include sales of digital assets, as contemplated by changes to Section 6045 under the Infrastructure Investment and Jobs Act of 2021. Brokers, as that term would now be defined (and as discussed further below), would be required to file information returns and furnish payee statements with respect to certain digital asset dispositions effected for customers. A new IRS form (1099-DA) would be created for this purpose. In addition to changes in broker reporting rules, the proposed regulations also provide some helpful guidance in determining how gains on dispositions of digital assets should be determined.

The regulations would have a delayed effective date and would first require reporting in 2026 for 2025 transactions (with certain aspects taking effect starting in 2027 for 2026 transactions).

A brief summary of some key provisions of the proposed regulations is set forth below.

Definition of digital assets and coordination with other provisions. The proposed regulations define digital assets as digital representations of value recorded on a cryptographically secured distributed ledger or similar technology. The definition is broad and encompasses various types of digital assets, including newer forms like stablecoins and non-fungible tokens (NFTs). The proposed regulations provide very limited exceptions to digital

asset treatment, including digital assets that exist in a closed ecosystem (such as a video game) or those that are only used for certain routine business tasks (such as tracking inventory).

The proposed regulations also include coordination rules between digital asset reporting and reporting for cash sales of securities, certain commodities, and with respect to real estate transactions in which gross proceeds are paid in cash or treated as cash for U.S. federal income tax purposes. Acknowledging that certain digital assets may also be classified as securities or commodities, the coordination rules specify that, if an asset constitutes both a security and a digital asset, brokers should report the sale of the asset as a digital asset sale rather than a security sale. Similarly, if an asset constitutes both a commodity and a digital asset, brokers should report the sale of the asset as a digital asset sale and not a commodity sale. For transactions involving digital assets that represent reportable real estate, brokers should only report these transactions as real estate sales and not digital asset sales.

Expanded definition of "broker." In what could be the most controversial aspect of the proposed regulations, Treasury and the IRS expand the scope of who constitutes a "broker" beyond a conventional understanding of who should be considered a digital asset broker. The term "broker" would include those providing facilitative services that effectuate sales of digital assets by customers, and who are in a position to know (rather than know or have reason to know) the identity of the customer and nature of the transaction potentially giving rise to gross proceeds. According to the proposed regulations, a person is in a position to know the identity of the customer if that person maintains sufficient control or influence over the facilitative services provided, so as to be able to set or change the protocol or service terms to request that the customer provide such information.

The proposed regulations aim to compel digital platform operators to collect and report customer sales information without regard to the manner in which they operate or effect such transactions. Treasury and the IRS have explicitly stated their intention for these proposed regulations to apply to both centralized and decentralized exchanges. While acknowledging that governance tokens in decentralized exchanges might be more widely distributed, Treasury and the IRS assert that even in structures where governance tokens are widely distributed, individuals or groups of token holders can still have the ability to maintain practical control, and thus qualify as "brokers" under the proposed regulations.

The proposed regulations would exclude providers of distributed ledger validation services (i.e., miners and stakers), provided that they do not provide other services that could cause them to constitute brokers. Also excluded are merchants who merely accept payment for their own goods or services in digital assets, as well as NFT creators.

Types of sales subject to reporting. Under the proposed regulations, a sale of digital assets includes the dispositions of a digital asset in exchange for cash, stored-value cards (including gift cards), or a different digital asset. In addition, a sale of a digital asset includes a disposition of a digital asset by a customer in exchange for services provided by a broker. For purposes of this rule, whether a person is a broker is determined without regard to whether that person regularly, as part of its trade or business, accepts digital assets in consideration for its services. Notably, a sale can be subject to reporting if it is recorded on a broker's books and records and need not be recorded on the blockchain. Moreover, the proposed regulations do not include any de minimis rules.

Real estate reporting. The proposed regulations require real estate reporting persons—such as title companies, closing attorneys, mortgage lenders, and real estate brokers who are treated as brokers for dispositions of digital assets—to file information returns and furnish payee statements with respect to real estate purchasers (not solely sellers, as under current rules) who use digital assets to acquire real estate and to include the fair market value of digital assets paid as consideration. The exceptions for residential sales where the gain is below the taxable threshold apply to digital assets as well.

Amount realized and basis determinations. The proposed regulations provide guidance in determining the taxpayer's amount realized when disposing of digital assets, which is the sum of the cash and the fair market value of any property (including digital assets) and services received, less any transaction costs (i.e., expenses paid in cash or property, including digital assets, to facilitate the disposition of digital assets). The proposed regulations include a special rule relating to transaction costs incurred in connection with an exchange of digital assets for other digital assets differing in kind. In general, 50% of such costs are allocated to the sale, and 50% are allocated to the acquired digital assets.

The proposed regulations also provide helpful guidance with respect to determining the basis of digital assets that have been sold (where less than all are sold). The proposed regulations generally permit specific identification of digital assets that have been disposed, rather than mandating a "first in first out" (FIFO) approach, where the taxpayer has maintained adequate identification of the time of the sale. Absent specific identification, FIFO would be required.

Conclusion

These proposed regulations mark the first phase of a broader plan to reform broker reporting for digital assets. Subsequent phases are expected to focus on implementing transfer statement reporting and broker information reporting for covered security transfers. If these proposed regulations are finalized in their current form, they will significantly impact the digital asset community, affecting brokers, traders, and other parties involved in digital asset transactions. In the preamble to the proposed regulations, Treasury and the IRS posed 51 specific questions on which they want input, and "strongly encourage" stakeholders to submit comments on the proposed regulations. This process is likely to attract a wide range of comments that could result in meaningful changes to some of the proposed rules. Written comments regarding the proposed regulations must be submitted by October 30, 2023. A public hearing is scheduled for November 7, 2023, with a potential second public hearing on November 8, 2023.

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