

I.R.S. ISSUES PROPOSED REGULATIONS ON INFORMATION REPORTING FOR DIGITAL ASSETS

Author
Wooyoung Lee

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INTRODUCTION

The I.R.S. recently issued the first of a set of what is expected to be several sets of proposed regulations to provide greater clarity on the application of information-reporting rules.

EXISTING LAW

I.R.S. Notice 2014-21 provides guidance on reporting digital assets received as compensation. However, the notice is silent on reporting the sale or exchange of digital assets or the use of digital assets to purchase product or services. The Proposed Regulations aim to fill that gap.

As the preamble explains, “digital assets” are digital representations of value that use cryptography to secure transactions that are digitally recorded using distributed ledger technology such as blockchains. Individual units are sometimes called coins or tokens. Digital assets include cryptocurrency (also known as virtual currency). Owners of digital assets can access their digital assets and conduct transactions with them using what is known as a wallet.

The following provisions of the Code already apply to sales of digital assets:

- Code §1001 and §1012 set the basic income-tax rules for applying cost basis and calculating gain apply to sales.
- Code §6041 requires a person who makes payments of \$600 in fixed or determinable income in the course of a trade or business to file information reports and furnish payee statements to the payee.
- Code §6045 requires brokers to file information returns and furnish payee statements for customers on whose behalf the broker sold shares of stock, certain commodities, options, regulated futures contracts, securities futures contracts, forward contracts, or debt instruments in exchange for cash.
- Code §6045A requires certain persons who transfer certain securities to a broker to furnish statements to the broker.
- Code §6045B requires certain securities issuers to provide reports to the I.R.S. and to shareholders regarding the effect on basis of certain organizational actions, such as stock splits, mergers, and acquisitions.
- Code §6050W requires banks and other entities to file information returns and furnish payee statements regarding certain payments in settlement of reportable payment transactions.

The Infrastructure Investment and Jobs Act

The Infrastructure Investment and Jobs Act of 2021 provided some guidance on the application of §6045 and §6045A:

- The term ‘broker’ specifically includes any person who regularly provides services effectuating transfers of digital assets on behalf of another person.
- “Specified securities” under §6045(g) (which requires that the information reported include basis and the character of the gain) explicitly include digital assets. The requirements under §6045(g) apply to digital assets acquired in 2023 or later.
- A “digital asset” is defined as any digital representation of value recorded on a cryptographically secured distributed ledger or any similar technology.
- Code §6045A specifically applies to digital assets and adds more reporting requirements for transfers of digital assets.
- These new provisions are not applicable for periods prior to the effective date of the new provisions.

NEW RULES

The proposed regulations are focused on Treas. Reg. §1.6045-1. Later rulemaking will focus on Code §6045A.

Expansion of Reporting Obligations

As it currently exists, Code §1.6045-1(a)(9) provides that Code §6045 comes into play only if the property disposed of is a security, commodity, option, regulated futures contract, securities futures contract, or forward contract in exchange for cash.

The proposed regulations add to this list a disposition of digital assets in exchange for cash, other digital assets, stored-value cards, broker services, or other property subject to Code §6045.

Defining Digital Assets

The proposed regulations use the same definition of “digital asset” as in the Infrastructure Investment and Jobs Act, underlining the importance of cryptography in the definition.¹ But an asset can be a digital asset even if not all transactions involving that asset are actually recorded on such ledgers. The example given in the preamble is a broker who carries out transactions between customers in its internal ledger and only uses the secured ledger to execute net purchases.

The definition is meant to capture traditional cryptocurrency as well as newer technologies, such as stablecoins or N.F.T.’s. However, the new rules do not cover tokens that can only be used in a computer game or digital representations of fiat currency (*e.g.*, U.S. dollars sitting in an online bank account).

The preamble explains that the classification of digital assets as securities is for the limited purpose of information reporting. A digital asset that might also be a

¹ Prop. Reg. §1.6045-1(a)(19)(i).

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security or commodity is to be treated as only a digital asset for reporting purposes.² One area left unresolved is conventional broker transactions that are carried out on blockchain technology. The proposed regulations decline to carve out an exception because of uncertainty over the frequency of such transactions, but that may change with the final or future regulations.

Defining Brokers

The proposed regulations expand the circumstances in which a person is a broker. The definition now covers a person that provides facilitative services that effectuate sales of digital assets by customers in the course of its trade or business. Whether someone effects transactions in digital assets on behalf of others depends on whether the person is in a position to obtain identity information.³ This phrasing reflects the fact that certain digital-asset trading platforms allow for a great deal of anonymity for its users. But the ability to modify the operation of a platform to obtain user information is treated as being in a position to know a user’s information. This is designed to prevent operators of platforms from deliberately raising the level of anonymity in their platforms in order to avoid reporting obligations.

The regulations are not intended to cover persons engaged in the business of providing distributed ledger validation services, such as proof-of-work or proof-of-stake mechanisms. Such persons are conventionally known as miners. Because miners are typically not in a position to know the identity of transacting parties, engaging solely in mining is excluded from the definition of brokers.⁴ For similar reasons, persons who are solely providers of wallet software are also excluded. But the exclusion is not available if the wallet software provides direct access to trading platforms from the wallet.

Defining Sales

Because digital assets are often exchanged for other digital assets instead of cash, the proposed regulations clarify that a sale includes a disposition of a digital asset for another digital asset.⁵

Required Information

Much of the information that a broker must report is similar to that for securities:⁶

- Customer’s name, address, and tax I.D.
- Name or type of digital asset sold
- Number of units sold
- Date and time of sale

² Prop. Reg. §1.6045-1(c)(8)(i).

³ Prop. Reg. §1.6045-1(a)(10).

⁴ Prop. Reg. §1.6045-1(a)(21)(iii)(A).

⁵ Prop. Reg. §1.6045-1(a)(9)(ii).

⁶ Prop. Reg. §1.6045-1(d)(2)(i)(B).

- Gross proceeds of sale
- Any other information required by the form (*i.e.*, Form 1099-B)

Information specific to digital assets that must be reported is as follows:

- Transaction identification (transaction I.D. or hash)
- Digital asset address from which the digital asset was transferred, if any (*i.e.*, the wallet's identifying code composed of alphanumeric characters)
- The nature of the consideration (*e.g.*, cash)

If a broker sells a digital asset that was held in a wallet on behalf of a customer, and the asset was previously transferred into the wallet, the broker must also report information on the previous transfer. However, this is intended to be a temporary rule until regulations concerning such transfers are issued under Code §6045A.

Gross Proceeds

The rules for calculating proceeds and gains do not depart greatly from standard income tax principles. Gross proceeds from a sale of a digital asset are defined as:⁷

- The excess of
 - cash received,
 - fair market value of property received (or the issue price for debt instruments received), and
 - fair market value of services received, over
- transaction costs.

Transaction costs are generally fees charged by brokers; they also include applicable transfer taxes.⁸ For administrative simplicity, transaction costs are allocated to the disposition of digital assets. With one exception, costs allocated to the receipt of property or services in exchange for the disposed-of digital asset) are not treated as reportable transactions costs.⁹ Under the exception, if one digital asset is exchanged for a materially different digital asset, the transaction costs are allocated 50-50 to the disposition of the original digital asset and the acquisition of the materially different digital asset.

Initial basis is similarly defined as the cost to purchase a digital asset plus allocable transaction costs.¹⁰

Basis Reporting

As mentioned previously, Code §6045(g) requires brokers to report basis information for certain assets. Only brokers who acquired digital assets for a particular customer, provided hosted wallet services (*i.e.*, held them in a wallet on behalf of the



⁷ Prop. Reg. §1.1001-7.

⁸ Prop. Reg. §1.6045-1(d)(5)(iv).

⁹ *Id.*

¹⁰ Prop. Reg. §1.1012-1(h).

customer), and held them until disposition are required to report basis.¹¹ In general, only these brokers have the information necessary to compute basis. This is contrasted with a customer who acquired the asset using another broker or a customer who mines digital assets on his or her own.

Basis reporting will likely become more extensive once regulations requiring reporting on transfers of digital assets under Code §6045A are issued, as that will give brokers the necessary information even if they did not acquire the digital assets themselves. In the meantime, brokers who can obtain basis information by other means can voluntarily report basis under the proposed regulations. The reward is a waiver from penalties under Code §6721 or Code §6722 for a failure to report such information correctly.¹²

Ordering Rules

If a customer has multiple units of the same digital asset with a broker, it is not always clear which units the customer wishes to sell off first. Under the proposed regulations, the customer is permitted to identify which units are being sold.¹³ If the customer does not provide such information, then the rules adopt a F.I.F.O. method (first in, first out.) Under that method, the units bought or transferred to the broker at the earliest point in time are considered sold first.

International Application

As with other types of income, digital-asset transactions involving non-U.S. persons trigger special reporting requirements. One threshold question is the determination of the geographic location of a transaction. As digital assets are bought and sold entirely online, the existing rules do not adequately address the issue.

The proposed regulations first classify a broker as a U.S. digital asset broker, a C.F.C. digital asset broker, or a non-U.S. digital asset broker.¹⁴ The latter two categories are further split into brokers that conduct activities as money services businesses (“M.S.B.”) and those who do not. As the names for each category suggests, sales by U.S. brokers are considered to take place in the U.S., while sales by the other two categories of brokers are considered to take place outside of the U.S.

U.S. digital asset brokers include U.S. persons, U.S. branches of foreign entities, foreign partnerships with controlling U.S. partners, U.S. trades or businesses, and foreign persons for which at least 50% of its gross income is considered to be effectively connected with a U.S. trade or business.¹⁵ While the rules for U.S. digital asset brokers are generally similar to existing rules for U.S. securities brokers, one difference is that securities brokers are allowed to accept and use evidence that a sale took place outside the U.S. The proposed regulations decline to adopt such a rule due to administrative complexity but invite comment on alternative approaches for distinguishing a U.S. digital asset broker’s U.S. activities from its non-U.S. activities.

C.F.C. brokers that do not conduct M.S.B. activities are treated in the same way as

¹¹ Prop. Reg. §1.6045-1(a)(15)(i)(J).

¹² Prop. Reg. §1.6045-1(d)(2)(iii)(A).

¹³ Prop. Reg. §1.6045-1(d)(2)(ii)(B).

¹⁴ Prop. Reg. §1.6045-1(g)(4).

¹⁵ Prop. Reg. §1.6045-1(g)(4)(i)(A).

U.S. brokers are treated. In other words, they must generally report all sales. But in comparison to U.S. brokers, they can accept documentary evidence rather than a withholding certificate that a recipient is an exempt foreign person and therefore not subject to reporting. C.F.C. brokers are also not required to perform backup withholding unless they have actual knowledge that the customer is a U.S. person.

Sales by non-U.S. digital asset brokers are presumed to take place outside the U.S., unless documentary evidence indicates otherwise. As with C.F.C. brokers, non-U.S. digital asset brokers are not required to collect backup withholding tax.

An M.S.B. is generally defined by FinCEN as a person that is doing business wholly or in substantial part in the U.S. as (i) a dealer in foreign exchange, (ii) a check casher (iii) an issuer or seller of traveler's checks or money orders, (iv) an issuer, seller, or redeemer of stored value, or (v) a money transmitter.¹⁶ Different rules apply for C.F.C. brokers and non-U.S. brokers that are M.S.B.'s because of FinCEN's greater concern about M.S.B.'s being used for money laundering. Accordingly, M.S.B. brokers are treated the same way as U.S. brokers – all sales are reportable and presumed to take place within the U.S.¹⁷

NEXT STEPS

Comments are requested by the end of October, with a public hearing to take place a week later. As mentioned previously, more proposed rules on reporting sales of digital assets are expected.

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¹⁶ 31 C.F.R. §1010.100(ff).

¹⁷ Pop. Reg. §1.6045-1(g)(4)(v).