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Treasury's proposed digital asset tax reporting regulations: A deep dive

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In August, the Internal Revenue Service and the Treasury Department proposed regulations expanding the scope of the tax reporting requirements for brokers to apply to sales of digital assets, including cryptocurrency. The proposed regulations include an expansive definition of "broker" that covers a wide range of entities, including DeFi platforms, and a similarly broad definition of "digital asset." Our client update explores the potential impact on participants in digital asset markets.

Background

On August 25, 2023, the U.S. Treasury Department (Treasury) and the Internal Revenue Service (IRS) released proposed regulations addressing tax information reporting by brokers on sales of digital assets, including cryptocurrency (the Proposed Regulations). The Proposed Regulations provide guidance implementing provisions of the Infrastructure Investment and Jobs Act of 2021 (the Infrastructure Act),[1] which modified existing securities and commodities broker reporting laws to require reporting by digital asset brokers.[2] Like the statutory changes, the Proposed Regulations modify and expand on longstanding regulations (the Existing Regulations) requiring brokers to report dispositions by customers of certain securities, commodities and derivative contracts.

The Proposed Regulations are generally expansive in nature, in terms of both the scope of entities treated as brokers and the types of transactions required to be reported. This client update highlights several of the most significant aspects of the Proposed Regulations, including that they generally:

- expand the definition of broker to cover a wide range of actors involved in digital asset transactions, including many "decentralized finance" (DeFi) platforms;
- define digital asset broadly to include stablecoins and non-fungible tokens (NFTs), among other assets;
- require a wide scope of digital asset dispositions to be reported, including dispositions in exchange for securities, commodities, other digital assets and broker services, in addition to dispositions for cash (which is generally the exclusive category of reportable "sales" under the Existing Regulations);
- create new rules addressing derivative transactions that either relate to digital assets or are themselves digital assets; and
- provide limited guidance on how to determine the amount realized on a sale, exchange or other disposition of a digital asset and how to calculate the basis of digital assets.

If the Proposed Regulations are finalized in their current form, their provisions will generally apply within the next two to three taxable years, with most rules applying to sales effected on or after either January 1, 2025, or January 1, 2026. However, certain rules will potentially apply earlier: for example, regulations regarding

Insights

[1] Public Law 117-58. "Section" references herein are to the Internal Revenue Code of 1986, as amended (the Code).
[2] The Proposed Regulations also include new proposed rules relating to real estate reporting and digital assets that are not discussed in this client update.

the determination of basis of digital assets and computations of gain or loss will apply in the taxable years following the calendar year in which the Proposed Regulations are finalized.

Moreover, the preamble to the Proposed Regulations (the Preamble) states that brokers and taxpayers should expect more rulemaking in this area, noting that the Proposed Regulations represent only one phase of Treasury's planned regulations. Among these expected future regulations are those addressing the requirement for brokers to report basis information upon transfers of digital assets. On September 29, 2023, Treasury released the 2023-2024 Priority Guidance Plan, which reaffirms its priorities set out in the Preamble. This Plan sets out Treasury's priorities in the twelve-month period from July 1, 2023 through June 30, 2024, which include providing guidance on tax treatment of transactions involving digital assets, regulations under Sections 6045A (related to reporting transfers of digital assets to brokers or certain other accounts) and 6050I (related to information reporting of digital assets received in a trade or business), as well as additional guidance on the tax treatment of transactions involving digital assets.

Definition of digital asset

The Proposed Regulations establish a broad definition of digital asset for purposes of the new information reporting regime.

Under the Infrastructure Act, a digital asset is "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology," except as otherwise established by Treasury.[3] The Proposed Regulations take a similar approach, defining a digital asset as a "digital representation of value that is recorded on a cryptographically secured distributed ledger (or similar technology)."[4]

The digital asset definition applies without regard to whether every transaction involving the digital asset is actually recorded on the applicable ledger.[5] As a result, transactions effected by a broker off-chain through adjustments to its own internal ledger are covered.[6]

The plain meaning of the words in the definition – and, in particular, the scope of the similar technology standard – leaves meaningful ambiguity. Nevertheless, the Preamble significantly clarifies how Treasury intends to view the definition. In particular, the Preamble makes the following observations:

First, the term digital asset is generally meant to apply broadly, and is not limited to virtual currency or fungible digital assets. Thus, Treasury intends for the definition to encompass assets such as NFTs, even if they arguably do not function as a representation of value.

Moreover, the Preamble clarifies that the definition includes stablecoins, which are generally intended to maintain a value that is pegged to another asset, typically a unit of fiat currency, and which often are used in lieu of fiat currency to effect other digital asset transactions. Commentators have questioned the utility of requiring brokers to report dispositions of stablecoins. In particular, in the case of a stablecoin tracking the U.S. dollar, a customer's gains and losses arising from the use of the stablecoin are likely to be very small.

To justify the decision to apply the Proposed Regulations broadly, the Preamble cites factors such as (i) Treasury's view that the definition of digital assets in the Infrastructure Act is expansive, (ii) Treasury's view that requiring reporting of gross proceeds and basis information would be helpful to taxpayers as well as the IRS, and (iii) the rapid evolution of technology in the crypto space.

Second, the definition is intended to be expansive *over time*, with the flexibility to encompass new types of digital assets as they are developed or as technology shifts. As the Preamble notes, in adopting the similar technology standard, Treasury intended to capture "digital representations of value that reflect advancements to the techniques, methods, and technology upon which digital assets are based." Consequently, as the technology underpinning digital assets evolves, so too will the potential universe of reportable digital asset transactions.

Finally, although the definition is broad, the Proposed Regulations and Preamble do note that it has limits. For example, the Proposed Regulations explicitly exclude cash, including fiat currency in digital form (*e.g.,* a

[3] Section 80603(b)(1)(D) of the Infrastructure Act.
[4] Proposed Treasury regulations section 1.6045-1(a)(19)(i).
[5] *Id*.
[6] Of note, this aspect of the Proposed Regulations implies an understanding that customers may be the beneficial owners for tax purposes of digital assets held by brokers in commingled or omnibus wallets.

central bank digital currency).[7] Moreover, the Preamble notes that the Proposed Regulations would not apply to assets that exist only in a closed system (such as video game tokens that can be purchased with U.S. dollars but can only be used in game), nor would they apply to distributed ledger technology used for ordinary commercial purposes, such as tracking inventory, which do not create new transferrable assets.

Certain digital assets might, under current tax law, be classified as securities or commodities, with the result that dispositions of such digital assets (for cash, at least) might be subject to the Existing Regulations. The Proposed Regulations sidestep the substantive question of whether particular digital assets are treated as securities or commodities for U.S. federal income tax purposes, instead providing a coordination rule that, according to the Preamble, seeks to avoid legal ambiguity and duplicate reporting obligations for brokers that trade digital assets that might also be either securities or commodities (dual classification assets). Specifically, the Proposed Regulations provide that, where a sale of a digital asset also constitutes a sale of securities (which generally include stocks and debt instruments, but do not include certain option contracts) or commodities, the applicable broker must report the sale only as a sale of a digital asset.[8] Similarly, the digital asset reporting rules generally take precedence over the rules for barter exchanges,[9] which is likely a favorable coordination rule for exchanges given that the barter exchange rules require separate Forms 1099 for each transaction as opposed to permitting aggregate reporting.

For bitcoin and ethereum, in particular, there had been uncertainty regarding whether these digital assets were commodities for purposes of the Existing Regulations. This ambiguity arose because the commodity definition applies to personal property on which futures contracts have been approved by the Commodity Futures Trading Commission (the CFTC).[10] However, current CFTC practice is to allow commodity exchanges to self-certify new futures contracts in lieu of explicit CFTC approval, including futures contracts on bitcoin and ethereum, creating ambiguity about whether these assets are commodities for the purposes of Section 6045. The Proposed Regulations clarify that assets subject to self-certified futures contracts are, in fact, commodities subject to reporting as such (unless they are also digital assets, as noted above).[11] Nevertheless, the Preamble acknowledges the prior uncertainty on this matter, and thus the Proposed Regulations' requirements to report such commodities (including bitcoin and ethereum) apply prospectively to sales that occur on or after January 1, 2025.

The Proposed Regulations helpfully clarify that the digital asset definition conveys no inference about whether a digital asset may be properly classified in some other way for other purposes of the Code, for example as a security or commodity.[12] This may be relevant, for example, to taxpayers seeking to treat certain digital assets as commodities for purposes of the mark-to-market rules under Section 475, the commodities trading safe harbor for non-U.S. persons under Section 864(b) or the publicly traded partnership rules under Section 7704.

Definition of broker

Like the definition of digital assets, Treasury's definition of broker for purposes of the Proposed Regulations is extremely broad. In constructing a broad definition, Treasury has clearly sought to achieve reporting of as many digital asset transactions as possible, including those on many automated platforms and even where there is significant potential for multiple reports on a single transaction.

In the context of securities reporting, the multiple broker rule under the Existing Regulations exempts brokers that conduct sales on behalf of other brokers from reporting, and only the broker that has the closest relationship to the customer is required to report information under section 6045.[13] However, while acknowledging the difference in treatment, the Preamble does not generally exempt from reporting sales by one broker facing another, and acknowledges that this may result in duplicative reporting. The Preamble notes that this approach was adopted, in part, due to concerns about a higher level of risk of no reporting under a similar multiple broker rule than is the case with traditional financial institutions.

In general, brokers required to perform information reporting are also required to perform backup withholding from the gross proceeds of a disposition if the customer is not exempt from backup withholding. The breadth

[7] *Id*.
[8] Proposed Treasury regulations section 1.6045-1(c)(8)(i).
[9] *See*, *e.g.*, proposed Treasury regulations section 1.6045-1(e)(2)(iii).
[10] Treasury regulations section 1.6045-1(a)(5)(i).
[11] Proposed Treasury regulations section 1.6045-1(a)(5)(i).
[12] Proposed Treasury regulations section 1.6045-1(a)(19)(ii).
[13] Treasury regulations section 1.6045-1(c)(3)(iii).

of the broker definition with respect to digital assets, in covering persons that may not ordinarily have custody of the relevant proceeds, as well as the possibility of multiple reporting brokers in a single transaction, raises questions about how the backup withholding requirements will operate without the possibility of multiple withholdings (each at 24% of the relevant proceeds). It is also unclear how backup withholding will operate where the gross proceeds consist of services or illiquid property rather than cash.

Existing definition of broker

The Infrastructure Act expanded the definition of broker to include any person who, for consideration, is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person. Commentators noted this definition was so broad that it could include persons such as digital asset miners and wallet software developers who would generally not have access to information necessary to perform tax reporting. Notably, six Senate Finance Committee members, in a letter to Treasury Secretary Yellen, requested that Treasury provide guidance limiting the scope of the broker definition, expressing concern that the statutory definition could apply to persons who validate distributed ledger transactions through mining, staking and other methods as well as developers of hardware and software solutions enabling users to maintain custody of their own digital wallets.

Under the Existing Regulations, the term broker is defined as any person that in their ordinary course of business stands ready to effect sales to be made by others.[14] The Existing Regulations further explain that the term middleman includes a person that as part of the ordinary course of a trade or business acts as an agent with respect to a sale if the nature of the agency is such that the agent ordinarily would know the gross proceeds of the sale.

As described below, changes to the terms used in the broker definition in the context of digital assets sweep in a wide array of service providers that assist end users with its dispositions of digital assets if they have the ability to change the terms under which the services are provided. The Proposed Regulations provide the following examples of persons generally considered brokers under the new rules: (i) persons who provide users with hosted wallet services; (ii) digital asset payment processors; (iii) persons who own or operate certain physical electronic terminals or kiosks; (iv) persons who operate certain non-custodial trading platforms or websites; and (v) certain persons who sell or license software to unhosted wallet users.[15]

Proposed changes to the definition of broker

Facilitative services

While allowing for a few specific exceptions, the Proposed Regulations expand the broker definition by interpreting "effecting a sale" broadly and including persons "in a position to know" rather than merely those who "ordinarily would know" the gross proceeds of a sale.

The Proposed Regulations expand the previous meaning of the term "effect" to include a digital asset middleman, defined as a person who provides facilitative services with respect to a sale of digital assets wherein the nature of the service arrangement is such that 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.[16]

A facilitative service is defined broadly as a service that directly or indirectly effectuates a sale of a digital asset, including: (i) providing a party in the sale with access to an automatically executing contract or protocol; (ii) providing access to digital asset trading platforms; (iii) providing an automated market maker system; (iv) providing order matching services; (v) providing market making functions; (vi) providing services to discover the most competitive buy and sell prices; and (vii) providing escrow or escrow-like services to ensure both parties to an exchange act in accordance with their obligations.[17]

"In a position to know"

A person would be in a position to know the identity of the seller if that person has the ability to change the terms under which its services are provided to request that the seller provide its name, address, and taxpayer identification number.[18] Similarly, a person would be in a position to know the nature of the

[14] Treasury regulations section 1.6045-1(a)(1).
[15] Proposed Treasury regulations section 1.6045-1(b)(1)(vi)-(xi).
[16] Proposed Treasury regulations section 1.6045-1(a)(21).
[17] Proposed Treasury regulations section 1.6045-1(a)(21)(iii)(A).
[18] Proposed Treasury regulations section 1.6045-1(a)(21)(ii)(A).

transaction (*i.e.*, to determine if the transaction is a sale, and the amount of gross proceeds) if the person has the ability to determine whether and the extent to which the transfer of digital assets involved in a transaction gives rise to gross proceeds.[19] An ability to change the fees charged for facilitative services is listed as one example of the ability to determine whether and the extent to which the transfer of digital assets involved in a transaction gives rise to gross proceeds.[20]

Treasury explained in the Preamble that, in proposing such a broad rule, it seeks to include in the scope of the Proposed Regulations persons who may otherwise have a policy of not requesting customer information, but who have the ability to obtain that information by, for example, updating their protocols. The Preamble acknowledges that the broad broker definition will sweep in parties not previously viewed as brokers.

The Proposed Regulations additionally broaden the definition of broker to include certain stablecoin issuers.

Sale includes payments to a digital asset payment processor

In addition to covering the more standard definition of sale, the Proposed Regulations apply to transfers of digital assets to payment processors that facilitate transfers of cash or other digital assets to a second party, for example in the purchase of goods or services.[21] This category of digital asset payment processor includes third party settlement organizations and payment card issuers that facilitate payments.

In the case of third-party settlement organizations, the Proposed Regulations offer a few examples to demonstrate how these organizations are digital asset payment processors subject to reporting as brokers.[22] In one example, a buyer contracts with a seller for non-digital asset services, and both parties have accounts with an organization that provides settlement services. The organization converts digital assets paid by the buyer into cash, which it delivers to the seller. As a result of this arrangement, the organization is a third-party settlement organization and a broker under the Proposed Regulations. [23,24]

Exceptions – Persons not treated as brokers

The Preamble acknowledges that persons engaged solely in certain tasks may not be in a position to know the identity of the parties entering into a sale. Accordingly, the Proposed Regulations exclude the following actions from independently qualifying as facilitative services: (i) the validation of distributed ledger transactions (whether through proof-of-work (*i.e.,* mining), proof-of-stake, or any other similar consensus mechanism) and (ii) the sale of hardware or license of software for which the sole function is to permit persons to control private keys which are used for accessing digital assets on a distributed ledger.[25] While reflecting some of the comments made by the Senate Finance Committee members upon passage of the Infrastructure Act, these exceptions are quite narrow.

Moreover, under the language of the Proposed Regulations, if a person is a broker in light of its other activities but also engages in one of these non-broker activities, such as mining, it is not clear whether the mining activity is exempt from reporting obligations or is within their scope due to the person's "broker" status.

Under the Infrastructure Act, a broker is a person that for consideration regularly acts as a middleman.[26] The Proposed Regulations narrow the "for consideration" part of the definition by limiting the universe of persons who will be deemed to be brokers to those who effect sales made by others "in the ordinary course of a trade or business."[27] This limitation is intended to exclude persons who only occasionally facilitate transfers of digital assets (even for consideration) from the definition of broker and therefore from the reporting requirements.

[19] Proposed Treasury regulations section 1.6045-1(a)(21)(ii)(B).
[20] *Id.*
[21] Proposed Treasury regulations section 1.6045-1(a)(9)(ii)(D).
[22] Proposed Treasury regulations sections 1.6045-1(b)(12), Example (12), 1.6045-1(b)(14), Example (14), 1.6050W-1(c)(5)(ii)(A), Example (1).
[23] Proposed Treasury regulations section 1.6050W-1(c)(5)(ii)(A), Example (1).
[24] The organization, under certain circumstances, may be subject to additional reporting requirements under proposed Treasury regulations section 1.6050W-1.
[25] Proposed Treasury regulations section 1.6045-1(a)(21)(iii)(A).
[26] Section 80603(a)(2) of the Infrastructure Act.
[27] Proposed Treasury regulations section 1.6045-1(a)(1).

Finally, merchants who accept digital assets in exchange for services, goods or other property, other than digital assets, are not treated as brokers if they are not otherwise required to perform information reporting under Section 6045.[28]

New rules for foreign brokers

The Proposed Regulations introduce a new regime for determining whether non-U.S. brokers are subject to the information reporting rules in respect of digital assets. While current law largely delineates non-U.S. brokers' obligations based on the physical location of the broker's office through which the sale is effected, the Proposed Regulations shift away from reliance on physical location and thereby generally expand the universe of circumstances in which foreign brokers may be required to report.

Current reporting regime for brokers and impetus for proposed changes

Under current law, while a U.S. broker must report sales effected at its U.S. and non-U.S. offices, a non-U.S. broker generally only reports sales it effects at a U.S. office.[29] For this purpose, certain non-U.S. persons with significant U.S. connections, including certain controlled foreign corporations (CFCs), are generally treated as U.S. brokers.[30] A sale is not effected at a U.S. office if the broker completes the acts necessary to effect the sale outside the United States pursuant to instructions directly transmitted to that office from outside the United States by the broker's customer, unless one of certain U.S. connections is present.[31]

In the Preamble, Treasury justifies a new approach for digital asset brokers by observing that the Existing Regulations "were written based on a business model for securities that assumed that brokers would have offices at physical locations where customer transactions may be booked, and that brokers would generally have direct, in-person contact with their customers." Digital asset brokers, in contrast, usually interact with customers entirely online, potentially crossing jurisdictional borders without necessarily having a branch or place of business in the jurisdiction where the customer is located.

Proposed changes to reporting for foreign brokers

The Proposed Regulations describe three separate categories: (i) U.S. digital asset brokers;[32] (ii) controlled foreign corporation digital asset brokers; and (iii) non-U.S. digital asset brokers.[33] For CFC digital asset brokers and non-U.S. digital asset brokers, the key distinction in the Proposed Regulations is between brokers that are money service businesses and those that are not, with the former having more expansive reporting obligations.[34]

CFC and non-U.S. digital asset brokers conducting activities as money services businesses
For CFC and non-U.S. digital asset brokers, the Proposed Regulations heighten their reporting obligations if the broker is conducting activities as a money services business with respect to its sales of digital assets. Generally, this is the case where the broker is registered with Treasury under 31 CFR 1022.380 (or any successor guidance),[35] which includes persons, wherever located, that do business wholly or in substantial part within the United States in the capacity of a dealer in foreign exchange, a check casher, an issuer or seller of traveler's checks or money orders, an issuer, seller, or redeemer of stored value, or a money transmitter. As the Preamble notes, this may include non-U.S. persons with no physical operations in the United States.

A CFC or non-U.S. broker that is a money services business must apply the rules applicable to U.S. digital asset brokers to determine where a sale is effected and the U.S. or non-U.S. status of a customer.[36] Thus, for example, a broker, the physical operations of which are entirely in Asia or Europe but that is regulated as a money services business, must report to the IRS information with respect to all sales effected for any customer unless the broker has established that an exemption applies (*e.g.*, the customer has provided to the broker an IRS Form W-8BEN).

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[28] Proposed Treasury regulations section 1.6045-1(b), Example 2(viii).
[29] Treasury regulations section 1.6045-1(a)(1).
[30] *Id*., incorporating by reference the definition of U.S. payor or middleman contained in Treasury regulations section 1.6049-5(c)(5) (which includes, among others, foreign partnerships majority-owned by U.S. persons and foreign persons the majority of whose income is "effectively connected" with a U.S. trade or business).
[31] Treasury regulations section 1.6045-1(g)(3)(iii)(A).
[32] As under the Existing Regulations, the U.S. digital asset broker category includes U.S. payors or middlemen under Treasury regulations section 1.6049-5(c)(5), other than CFCs. *See* proposed Treasury regulations section 1.6045-1(g)(4).
[33] Proposed Treasury regulations section 1.6045-1(g)(4).
[34] Proposed Treasury regulations section 1.6045-1(g)(4)(i)(D).
[35] *Id*.
[36] Proposed Treasury regulations section 1.6045-1(g)(4)(v).

Even for non-U.S. brokers that are money services businesses, the Proposed Regulations provide an exemption for sales effected at a foreign kiosk. Foreign kiosks are physical electronic terminals (i) that are located outside the United States and (ii) are owned or operated by a digital asset broker not required to implement anti-money laundering programs and other requirements under the Bank Secrecy Act.[37]

Importantly, the Preamble states that Treasury is considering expanding the application of the money services business rules to CFC and non-U.S. digital asset brokers regulated by other U.S. regulators, such as the Securities and Exchange Commission, the Commodity Futures Trading Commission, and banking regulators such as the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, raising the possibility of additional non-U.S. brokers being treated like U.S. brokers under the Proposed Regulations.

Non-U.S. and CFC digital asset brokers not conducting activities as a money services business

For non-U.S. digital asset brokers that are not conducting activities as a money services business, sales of digital assets are generally considered to be effected at an office outside the United States.[38] Consequently, these non-U.S. digital asset brokers are not generally subject to broker reporting obligations.

Notwithstanding this general rule, however, sales are considered to be conducted at an office inside the United States if (before the sale is effected) the broker collects documentation or has certain other information that suggests that the customer to which the sale being made has certain indicia relating to the United States.[39] These indicia include items such as a customer's IP address indicating a location within the United States, a U.S. mailing address for a customer, or the transfer of funds into an account maintained by the customer in the United States.[40] If these U.S. indicia cause a sale to be treated as effected in the United States, the information reporting requirements apply unless the digital asset broker determines the customer is an exempt foreign person (*e.g.*, the customer has provided to the broker an IRS Form W-8BEN).[41]

Generally, a sale of a digital asset effected by a CFC digital asset broker that is not a money services business is considered to be effected at an office outside the United States.[42] However, the reporting obligations for these sales under the Proposed Regulations are greater than the corresponding reporting obligations for other non-U.S. digital asset brokers. Like a U.S. digital asset broker, a CFC digital asset broker must report all sales other than those effected by an exempt foreign person.[43] However, in contrast to a U.S. digital broker, which generally must obtain a valid beneficial withholding certificate to determine a customer is an exempt foreign person, a CFC digital asset broker is entitled to rely on certain documentary evidence, such as an identification issued by a non-U.S. government.[44]

Gross proceeds reporting – Expansion of the existing regulations to cover dispositions of digital assets for non-cash items

New types of transactions subject to reporting

As noted, while the Existing Regulations apply only to dispositions in exchange for cash, the Proposed Regulations expand the definition of a sale – solely in the context of digital asset dispositions – to cover new categories of non-cash proceeds. Under the Proposed Regulations, a sale includes an exchange of a digital asset for: (i) stored-value cards (including cards with a prepaid value of any digital asset);[45] (ii) a different digital asset;[46] (iii) in the case of a broker effecting property sales for others, such property (*e.g.,* securities) if property is subject to broker reporting;[47] and (iv) services of a broker.[48] The definition of broker for purposes of this rule (iv), treating broker services as reportable gross proceeds, is more expansive than the definition of broker discussed elsewhere in this client update. For example, the Preamble states that if a stockbroker

[37] Proposed Treasury regulations section 1.6045-1(g)(4)(i)(E). References herein to the "Bank Secrecy Act" are to 31 USC 5311.
[38] Proposed Treasury regulations section 1.6045-1(g)(4)(iv)(A).
[39] Proposed Treasury regulations section 1.6045-1(g)(4)(iv)(B).
[40] *Id.*
[41] Proposed Treasury regulations section 1.6045-1(g)(4)(iv)(D)(1).
[42] Proposed Treasury regulations section 1.6045-1(g)(4)(iii)(A).
[43] *See* Proposed Treasury regulations section 1.6045-1(a)(1).
[44] Proposed Treasury regulations section 1.6045-1(g)(4)(iii)(B).
[45] Proposed Treasury regulations section 1.6045-1(a)(9)(ii)(A)(1).
[46] Proposed Treasury regulations section 1.6045-1(a)(9)(ii)(A)(2).
[47] Proposed Treasury regulations section 1.6045-1(a)(9)(ii)(B).
[48] Proposed Treasury regulations section 1.6045-1(a)(9)(ii)(C).

accepts a digital asset as payment for the commission charged for a stock purchase, the customer's disposition of the digital asset in exchange for the broker's services will be treated as a sale of the digital asset for these purposes because the stockbroker is a broker due to the fact that it regularly effects sales of stock (not because it regularly accepts digital assets for services). Finally, a sale would include a delivery of a digital asset in settlement of a financial contract.[49]

The expansion of the broker reporting requirements to dispositions of digital assets other than for cash is likely to create uncertainty for brokers regarding situations where the substantive treatment of the transaction is unclear, and in particular where it is unclear if a taxable disposition has occurred. For example, loans of digital assets, wrapping of digital assets to create other digital assets and exchanges of digital assets for other digital assets in connection with DeFi transactions may require brokers to make reporting decisions notwithstanding uncertain treatment of the transaction.

The Preamble clarifies that hard forks and airdrops are not treated as sales under the Proposed Regulations. Specifically, a sale does not include a transaction in which a customer receives new digital assets without disposing of a digital asset in exchange, as would be the case in a hard fork transaction or a receipt by a customer of digital assets from an airdrop.

Valuation

In expanding sales to include dispositions for items other than cash, the Proposed Regulations require brokers to make valuation determinations that they are not currently required to make.

The Proposed Regulations set out the general formula for calculating the amount realized on dispositions of digital assets as the sum of: (i) any cash received; (ii) the fair market value of any property received (including digital assets) or, in the case of a debt instrument issued in exchange for the digital assets, the issue price of such debt instrument;[50] and (iii) the fair market value of any services received, reduced by the allocable digital asset transaction costs.[51]

In determining gross proceeds received in a transaction involving digital assets, the broker must determine the fair market value of property or services received by the customer, measured as of the date and time the transaction was effected.[52] The Proposed Regulations require the broker to use a reasonable valuation method that looks to contemporaneous evidence of value of the services or other property.[53] This evidence includes, but is not limited to, the purchase price of the services, goods or other property, the exchange rate, and the U.S. dollar valuation applied by the broker to effect the exchange.[54] In making valuation determinations, a broker may perform its own valuations or rely on valuations performed by a digital asset data aggregator.[55]

The disposition of digital assets to pay digital asset transaction costs (including digital assets withheld) constitutes a disposition of digital assets for services. As a result, the total gross proceeds received when digital assets are used to pay these costs include, in addition to cash or other items received, the value of the services received in making the disposition. The Proposed Regulations define digital asset transaction costs to mean the amounts paid to effect the disposition or acquisition of a digital asset. These amounts include (i) transaction fees paid to a digital asset broker and (ii) transfer taxes that apply.[56]

In determining the fair market value of services giving rise to digital asset transaction costs, a broker must look to the fair market value of the digital assets used to pay for such digital asset transaction costs. Treasury's rationale for this different approach is that the value of digital assets used to pay for digital asset transaction costs is likely to be significantly easier to determine than any other measure of the value of services giving rise to those costs. While this rule does not apply to valuing services as a general matter, if the broker reasonably determines that the value of services or property received cannot be valued with reasonable accuracy, the fair market value of the received services or property must be determined by reference to the fair market value of the transferred digital asset.[57] If the broker reasonably determines that

[49] These include forward contracts, options, regulated futures contracts, and any similar instruments. *See* Proposed Treasury regulations section 1.6045-1(a)(9)(ii)(A)(3).
[50] The basis of digital assets acquired in exchange for the issuance of a debt instrument is determined under existing Treasury regulations. *See* Treasury regulations section 1.1012-1(g). *See* Treasury regulations sections 1.1273-2, 1.1274-2.
[51] Proposed Treasury regulations section 1.1001-7(b)(1).
[52] Proposed Treasury regulations section 1.6045-1(d)(5)(ii)(A).
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] Proposed Treasury regulations section 1.6045-1(d)(5)(iv).
[57] Proposed Treasury regulations section 1.1001-7(b)(4).

neither of the two can be valued with reasonable accuracy, the broker must report an undeterminable value for gross proceeds from the transferred digital asset.[58]

Treatment of transaction expenses and commissions

Under the Existing Regulations, for sales on or after January 1, 2014, brokers must reduce gross proceeds by the amount of commissions and transfer taxes related to the sale of the security.[59] Similarly, for purposes of satisfying a broker's obligation to report the adjusted basis of covered securities that are sold, the initial cost basis of a security that is acquired for cash is the total amount of cash paid by the customer, increased by the commissions and transfer taxes related to its acquisition.[60] For example, a broker must report as basis the premium paid plus any costs (*e.g.*, commissions) related to the acquisition of an option and must report as proceeds the gross proceeds from settlement minus any costs related to the settlement of the option.[61]

Building upon the existing framework, the Proposed Regulations create a more comprehensive regime obligating brokers to report digital asset transaction costs associated with a digital asset disposition or acquisition, as described above under the heading "*Valuation*." These rules generate particular complexity where the costs are themselves satisfied in digital assets: that disposition must be reported as its own sale in the context of the broader digital asset acquisition or disposition.

In a digital asset disposition transaction, the digital asset transaction costs are generally allocable to the disposition of the digital assets and therefore reduce the gross proceeds reported.[62] However, in the context of an exchange of a digital asset for another materially different digital asset, only one-half of the digital asset transaction costs is allocated to the disposition, with the other half being allocated to the acquisition. As a result, differing consequences may arise from similar transactions: in a disposition of digital assets for $100 in cash, involving $2 of digital asset transaction costs paid in cash, the gross proceeds would be $98. In this example, the transaction costs are paid by the seller using cash on hand. In a similar disposition of digital assets for units of a U.S. dollar-pegged stablecoin worth $100, the gross proceeds would be $99 and the taxpayer's basis in the stablecoin units would be $101 because the $2 of transaction costs (again, paid in cash) would be split between the disposition and the acquisition of the stablecoin units.

Basis reporting rules

General rules on basis reporting

In addition to requiring brokers to report dispositions of digital assets, the Proposed Regulations add digital assets to the categories of assets for which a broker must track its customer's cost basis.

A customer's basis for a digital asset is generally equal to the sum of (i) the cost thereof and (ii) any allocable digital asset transaction costs (as described above).[63] Otherwise, the cost is the fair market value used in determining the amount realized on the disposition of the transferred property.

The Proposed Regulations mandate that brokers providing custodial services for digital assets begin reporting adjusted basis for sales of digital assets effected on or after January 1, 2026, if the digital asset was acquired and has been continuously held by that broker in the customer's account on or after January 1, 2023.[64] The requirement to track basis is, therefore, effectively retroactive, which may pose difficulties for many brokers, particularly those whose broker status was not clear prior to the release of the Proposed Regulations. Treasury states in the Preamble that it views taxpayers as having had sufficient notice of the requirement to track this information from the Infrastructure Act, given that the statute would have required this reporting for assets acquired in 2023.[65]

By contrast, sale transactions effected by custodial brokers of digital assets that were not previously acquired in the customer's account and sale transactions effected by non-custodial brokers (for example, by decentralized exchanges) are not subject to these mandatory basis reporting rules. For example, a broker

[58] Proposed Treasury regulations section 1.6045-1(d)(5)(ii)(B).
[59] Treasury regulations section 1.6045-1(d)(5)(i).
[60] Treasury regulations section 1.6045-1(d)(6)(ii)(A).
[61] Treasury regulations section 1.6045-1(m)(4)(ii).
[62] Proposed Treasury regulations section 1.6045-1(d)(5)(iv).
[63] Proposed Treasury regulations section 1.1012-1(h)(1)(i).
[64] Proposed Treasury regulations section 1.6045-1(d)(2)(i)(C).
[65] Section 80603(b)(1) of the Infrastructure Act.

that receives a customer's digital assets that were acquired for that customer by another broker may not have the information necessary to determine the customer's basis, and is as a result not subject to the mandatory basis reporting. However, the Preamble notes that this reporting landscape is likely to evolve once future rulemaking under Section 6045A(a) is complete.

Identification of disposed units of digital assets

Under the Proposed Regulations, if a taxpayer disposes of fewer than all the units of the same digital asset held within a single wallet or with a broker, the basis of the units disposed may be determined by a specific identification of the units of such asset.[66] Failure by a taxpayer to identify the units to be disposed of would require the units to be identified on a first in, first out (FIFO) basis within the relevant wallet or account.[67] This approach adopted by the Proposed Regulations, while providing some helpful detail, generally follows the approach previously set out by Treasury in the frequently asked questions on virtual currency transactions posted on the Internal Revenue Service's website, although the FAQs did not specifically address virtual currency held through a broker or state a required time for the specific identification.

For digital assets not held in the custody of a broker, a taxpayer may specifically identify on its books and records, no later than the date and time of the sale, the particular units within a wallet or account to be disposed of by reference to any identifier (*e.g.*, the purchase date and time; the purchase price for the unit). A specific identification is only available if adequate records are maintained for all units of a specific digital asset in a wallet or account such that the taxpayer can identify the removed units.[68]

In the case of digital assets held at a broker, the identification of the units must be through the broker rather than the taxpayer's books or records. The taxpayer needs to identify, no later than the date and time of the disposition, the disposed of assets in a way that the broker designates as sufficiently specific to allow the broker to determine their basis and holding period. The Proposed Regulations generally put the burden of maintaining sufficient records to substantiate the identification on the taxpayer.[69]

The Proposed Regulations also provide that a change of method of identification – for example, from "disposition of assets starting with the latest acquired" to "disposition of assets starting with the highest basis" – does not constitute a change in the method of accounting under Sections 446 and 481.[70] This approach to changes in a digital asset method of identification is consistent with the existing Treasury regulations' approach for changes in method of stock identification.[71]

Derivative transactions

The Proposed Regulations expand the reporting regime for financial contracts related to digital assets explicitly to cover options on digital assets (and on derivatives with digital assets as underlying property)[72] and certain forward contracts.[73] Specifically, the Proposed Regulations further expand the definition of forward contracts to include executory contracts that require delivery of a digital asset in exchange for a range of assets (including different digital assets).[74]

However, no changes have been proposed with respect to regulated futures contracts, because the definition of a regulated futures contract in existing Treasury regulations can already apply to regulated futures contracts on digital assets and to regulated futures contracts that are themselves digital assets.[75]

For the various situations involving derivative transactions, the Proposed Regulations set forth reporting rules that depend on the nature of the derivative and whether the transaction involves a sale of the derivative itself or the settlement of the derivative through physical delivery of the underlying property.[76]

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[66] Proposed Treasury regulations section 1.1012-1(j)(1).
[67] Proposed Treasury regulations section 1.1012-1(j)(3)(i). Under proposed Treasury regulations section 1.1012-1(j)(1), units in the wallet or account are disposed of in order of time from the earliest acquired.
[68] Proposed Treasury regulations section 1.1012-1(j)(2).
[69] Proposed Treasury regulations section 1.1012-1(j)(3)(ii).
[70] Proposed Treasury regulations section 1.1012-1(j)(4).
[71] Treasury regulations section 1.1012-1(c)(10).
[72] Proposed Treasury regulations section 1.6045-1(m)(1).
[73] Proposed Treasury regulations section 1.6045-1(a)(7)(iii).
[74] *Id.*
[75] Treasury regulations section 1.6045-1(a)(6).
[76] Proposed Treasury regulations section 1.6045-1(a)(9)(ii)(A)(3).

For derivatives that relate to digital assets, or that are themselves digital assets, and that are Section 1256 contracts, the Proposed Regulations generally default to requiring reporting that would otherwise apply to Section 1256 contracts under the current broker reporting rules. Section 1256 contracts are generally defined under existing law to include any regulated futures contract, foreign currency contract, nonequity option, dealer equity option, or dealer securities futures contract.[77] The physical settlement of these derivatives is treated as two separate events: the termination of the Section 1256 contract itself (generating its own profit or loss) and the delivery of the underlying property.

For a non-Section 1256 derivative, a disposition of the derivative contract is reported under the digital asset rules if the derivative is itself a digital asset, and the Existing Regulations if it is not. On the other hand, the delivery of a digital asset pursuant to a settlement of a forward, option or other similar contract constitutes a sale of the underlying asset.[78] Therefore, if the derivative is physically settled through delivery by the customer of the underlying asset, reporting will occur under the rules for digital assets if the underlying property is a digital asset and under the Existing Regulations if the underlying property is not a digital asset but is otherwise reportable.

On the other hand, entering into a digital asset contract that requires delivery of personal property, the initial grant or purchase of a digital asset option, or the exercise of a purchased digital asset call option for physical delivery is generally not included in the definition of sale under the Proposed Regulations.

Effective dates and expected future rules

In the event the Proposed Regulations are finalized in their current form,[79] their provisions would generally become applicable within the next two to three taxable years.

Many of the central provisions of the Proposed Regulations are proposed to become effective on or after January 1, 2025. For example, provisions requiring brokers to report gross proceeds from sales of digital assets would apply to sales of digital assets effected on or after January 1, 2025, rules regarding third party settlement organizations and payment card issuers described above under "*Definition of broker – Proposed changes to the definition of broker"* would apply to payments made on or after January 1, 2025, and rules relating to penalties for failing to file or furnish an information return and backup withholding would apply, respectively, to information returns required to be filed and sales occurring on or after January 1, 2025. Other rules would take effect later: as described in "*Basis reporting rules*," above, the Proposed Regulations mandate that brokers providing custodial services for digital assets provide adjusted basis reporting for sales of digital assets effected on or after January 1, 2026 if the digital assets were acquired and continuously held by that broker in the customer's account on or after January 1, 2023.

Regulations regarding the basis of digital assets and the computations of gain or loss would apply in the taxable years following the calendar year following the date the Proposed Regulations are finalized. However, the Preamble notes that a taxpayer may rely on the Proposed Regulations for computing basis and gain or loss, so long as the taxpayer follows the Proposed Regulations under Section 1001 and 1012 consistently and in their entirety.

Finally, the Preamble notes that taxpayers in the digital asset space should expect further proposed regulations affecting reporting obligations, and notes that the Proposed Regulations represent only one phase of Treasury's planned regulations in the area. Specifically, while the Proposed Regulations generally focus on changing existing Treasury regulations section 1.6045-1 to require brokers to report digital asset sales, the Infrastructure Act also requires transfer statement reporting under Section 6045A(a) for covered securities that are digital assets and includes new information reporting provisions under Section 6045A(d) requiring broker reporting of certain transfers of digital assets that are covered securities (which, in each case, requires brokers to report certain basis information upon transfers). The Preamble notes that Treasury expects future regulations to focus on these provisions.

Law clerk Jeff Metzger contributed to this update.

[77] Section 1256(b).
[78] Proposed Treasury regulations section 1.6045-1(a)(9)(ii)(A)(3).
[79] For the purposes of the discussion in this section, this client update assumes the Proposed Regulations are finalized and the applicability dates are unchanged upon finalization.

Davis Polk

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