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Proposed Treasury Regulations Expand Tax Information Reporting on Digital Asset Transactions

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On August 25, 2023, the U.S. Treasury and IRS released the long-awaited proposed regulations on digital asset tax information reporting requirements. The proposed regulations provide guidance on statutory amendments to broker reporting rules enacted as part of the Infrastructure Investment and Jobs Act of 2021 (“Infrastructure Act”) and are issued principally under Section 6045 of the Internal Revenue Code (“Code”). Regulations under other provisions of the Code, however, are also amended in coordination with these rules, including provisions under Sections 6050W, 1001 and 1012.

At close to 300 pages, the new proposed regulations contain an expansive framework for addressing information reporting related to dispositions of (including payment using) crypto assets. The purpose of these rules is to require “brokers,” which would include traditional custodial brokers as well as certain decentralized exchanges or marketplaces and digital payment processors, to report to both the IRS and the customer dispositions of digital assets. The intent is that this would increase tax compliance by (1) allowing the IRS to verify a taxpayer’s income from digital asset transactions and (2) providing taxpayers tax-relevant information for filing their tax returns.

The proposed regulations are a challenging read. They implement rules through multiple series of amendments to existing definitions as well as new definitions, often leveraging on existing broker reporting rules but also other information reporting principles (e.g., documentation rules for exempt foreign persons) and the specific facts surrounding different digital asset industry participants. The new proposed regulations,

however, contain an extensive preamble and numerous examples which are useful for understanding the intended operation of the rules.

The following is a summary highlighting significant provisions of these new proposed regulations. More detailed analysis of rules impacting specific industry participants will be released separately.

A. Scope: Who and What is In or Out?

Determining who or what the proposed regulations would apply to is not a straightforward exercise. The definitions of “broker” and “digital assets” have been left relatively broad, and the scope of these rules are instead largely determined by a series of interconnected definitions such as “sale,” “effect,” and new definitional categories such as “Digital Asset Middleman” and “Digital Asset Payment Processor.”

In terms of the definition of “broker,” a broker is defined broadly as any U.S. or non-U.S. person that, in the ordinary course of a trade or business stands ready to effect sales made by others. This definition includes a person that regularly offers to redeem digital assets that were created or issued by that person (e.g., potentially capturing certain new coin and stablecoin issuers) and certain reportable persons required to report on dispositions of real property.

“Digital Asset” is defined as any digital representation of value that is recorded on a cryptographically secured distributed ledger (or similar technology), without regard to whether each individual transaction involving that digital asset is actually recorded on that ledger and that is not cash. Again, the definition is broad and can encompass virtual currencies, nonfungible tokens (NFTs) as well as other digital asset tokens that make use of distributed ledger technology.

Reporting of sales of digital assets, however, is generally required only for a “sale” by a “customer” of the broker if, in the ordinary course of a trade or business in which the broker stands ready to “effect” sales to be made by others, the broker effects the sale or closes the short position opened by the sale. Sales for this purpose can be recorded on a broker’s books and records and does not necessarily have to be recorded as a transaction on the blockchain.

Because of the structure of the regulations, the determination as to the scope of who or what is in or out requires an understanding of the definitional terms.

1. Industry Participants In-Scope and Out-of-Scope

(a) Generally In-Scope. When we parse through the definitions, the following industry participants are generally within the scope of the broker reporting regulations:

- Custodial brokers
- Issuers of digital assets that regularly redeem such assets (e.g., certain issuers of new coins or stablecoins)
- Certain decentralized exchanges that fall within the new category of “Digital Asset Middleman” (discussed below)
- Digital Asset Payment Processors (discussed below)
- Real Estate Reportable Persons (discussed below)

Custodial digital asset brokers are ones that act in the role of traditional brokers. Digital assets are generally held in the custody of the broker (i.e., the broker has control over private keys to the wallets holding the digital assets) and act as agent for the customer on trades. The other categories may require additional explanation (discussed below).

(b) Out-of-Scope. The proposed regulations exclude several types of participants from the broker reporting requirements. These include blockchain transaction validators (e.g., miners on proof of work blockchains and validators on proof of stake blockchains) whose sole activity is the validation of transactions on a blockchain. They also include sellers of hardware and software wallets the sole function of which is to that allow users to control private keys for accessing their digital assets. However, if the wallet platform provides users with direct access to trading platforms, the providers remain in-scope under the regulations.

Also excluded from broker reporting are merchants that accept digital assets directly on a sale of their own goods or services and NFT creators who mint and sell their own NFTs.

(c) Decentralized Platforms. As noted above, certain decentralized digital asset platforms may fall within the scope of the proposed regulations if they are treated as a “Digital Asset Middleman.” This analysis revolves largely around platforms, even where transactions are automatically executed under smart contracts, where a person or group of persons maintains sufficient control over the contracts to be deemed able to collect customer information and report on sales transactions.

A “Digital Asset Middleman” includes a person that provides a service that directly or indirectly effectuates a sale of digital assets AND where the person knows or is in a position to know the:

- Identity of the party making the sale; and
- Nature of the transaction giving rise to gross proceeds from the sale.

To be in a position to know the identity of the party making the sale means retaining sufficient control or influence to have the ability to set or change the terms under which the services are provided to request that the party making the sale provide that party’s name, address, and taxpayer identification number (TIN).

To be in a position to know the nature of the transaction means a person maintains sufficient control or influence over provided services to have the ability to determine whether and the extent to which the transfer of digital assets involved in a transaction gives rise to gross proceeds.

A person with the ability to change the fees charged for the service is an example of a person that maintains such sufficient control and influence.

(d) Digital Asset Payment Processors. As noted in the summary above, certain digital asset payment processors are required to conduct reporting on digital asset payments (which are treated in this case as dispositions of the digital asset).

The term “digital asset payment processor” means a person who in the ordinary course of a trade or business stands ready to effect sales of digital assets by:

- Regularly facilitating payments from one party (e.g., buyer) to a second party (e.g., vendor or seller) by receiving digital assets from the first party and exchanging those digital assets into cash or different digital assets paid to the second party;
- Acting as a third-party settlement organization (a TPSO under section 6050W) that facilitates payments, either by making or submitting instructions to make payments, using one or more digital assets in settlement of a reportable payment transaction under section 6050W, without regard to whether the TPSO contracts with an agent to make, or to submit the instructions to make, such payments; or
- Acting as a payment card issuer that facilitates payments, either by making or submitting the instruction to make payments, in one or more digital assets to a merchant acquiring entity in a transaction that is associated with a payment made by the merchant acquiring entity, or its agent, in settlement of a reportable payment transaction under the merchant payment card rules of section 6050W.

(e) Real Estate Reportable Persons. Finally, the regulations contemplate that where consideration for real estate transactions or real estate broker services is made in part or whole in digital assets, real estate

reporting persons (as defined in Reg. 1.6045-4(e)) would also need to report the sale of these assets. These are usually the persons managing the closing and who currently issue the Form 1099-S for the sale to the seller. Under the rubric of the proposed regulations, if a buyer pays with digital assets, the real estate reporting person would need to report the sale to the buyer. Thus, this would require a process change.

2. Dispositions of Digital Assets within Scope

In addition to determining who is subject to reporting, an additional inquiry is whether the type of digital transaction is reportable. The proposed regulations provide nuanced rules on what types of digital asset transactions are subject to reporting. The following digital transaction types are in-scope:

- Disposition of digital assets for cash, stored value cards, broker services or other reportable property (including other digital assets)
- Delivery of a digital asset pursuant to the settlement of a forward contract, option, regulated futures contract, any similar instrument, or certain other executory contracts
- Disposition of digital asset in a reportable real property transaction
- Payments to Digital Asset Payment Processors (noted above)
- Digital assets that may themselves be treated as securities

B. Reportable Information on Sales and Phased-In Timing

The proposed regulations provide a separate set of data points to be reported by brokers with respect to reportable transactions. These rules apply to applicable digital asset sales occurring on or after January 1, 2025.

Given that the regulations are not yet final, this is a very short time frame for any system builds that would be required to accommodate compliance with the regulations. This is especially so for digital asset businesses that do not have existing tax information reporting systems in place. Business requirements documents will need to be written, and systems will need to be coded for the requirements, implemented, and tested. This process generally would take at least 18 months from issuance of final guidance. Even for firms with existing tax information reporting functions, the regulations require data points for digital assets reporting that differ from those required for traditional securities reporting.

Due to these time constraints, industry participants may need to begin assessing their current systems, processes, and functionality against the requirements of the proposed regulations. They may need to assess the feasibility of building systems or utilizing vendor systems. A further evaluation would then need to be made when final regulations are issued to update for regulatory changes.

1. General Data Elements

The proposed regulations require specified information to be reported on digital asset sales occurring on or after January 1, 2025:

Customer Information	Transaction Information	Transfer Information
Customer Name	Digital Asset (DA) Name	Transfer Date and Time
Customer Address	Digital Asset Quantity (units)	Transfer Transaction ID
Customer TIN	Sale Date and Time	Transfer from Wallet Address(es)
	Gross proceeds	Transfer Quantity (units)
	Transaction ID	
	Wallet Address(es)	
	Sale For Info (cash, cards, services, property)	

2. Cost Basis Reporting

Cost basis reporting, including reporting of whether any gain or loss is long-term or short-term and the acquisition date, would be required for digital assets that are “covered securities” for sales occurring on or after January 1, 2026.

The following points may be worth noting in relation to covered securities/cost basis reporting:

- With respect to digital assets, covered securities currently means only digital assets acquired on or after January 1, 2023, for cash, stored value cards, broker services or other property and maintained in a broker custodial account for the entire period of time from acquisition date to sale;
- Note, however, that options on digital assets (or derivatives of digital assets) that are not themselves digital assets may be treated as covered securities if granted or acquired on or after January 1, 2023, if they otherwise meet the requirements relating to broker reporting of options generally;
- Certain forward contracts on digital assets (where the contracts themselves are not digital assets) that are disposed of before delivery acquired on or after January 1, 2023, would be treated as covered securities;
- The requirement for cost basis reporting is currently limited to the situations above, pending additional guidance from the Treasury and the IRS under section 6045A and section 6045B, that relate to transfer reporting and organization actions reporting. Once the guidance is issued, the scope of covered securities with respect to digital assets is expected to expand.
- It is important also to note that a sale of a covered security on or after January 1, 2026, may be with respect to digital assets acquired as early as January 1, 2023, requiring an ability of the system to trace back the original acquisition cost information.

3. Relief Methodology for Brokers

Where not all lots within a position are sold in a transaction, the proposed regulations require a broker to follow the specific identification of the lots subject to the sale as provided by a notice from the customer to the broker. If the customer has not notified the broker, the broker is required to use a first-in first-out (FIFO) method in determining the lots that are subject to the sale.

4. Special Considerations for Forwards, Options and Regulated Futures Contract

Different derivative contracts are treated differently for reporting purposes, which will add to the reporting complexity.

(a) Forwards. For a forward contract where there is delivery of the underlying digital asset, the reportable transaction is the delivery under the contract. The broker is not required to separately report gain or loss on the contract vs the delivery of the underlying asset in a transaction where delivery occurs. However, if the forward is disposed of prior to delivery, that disposition is a reportable event.

(b) Options. For options that are classified as digital assets (digital asset options), these are reported like other digital assets. For options that are not classified as digital assets (non-digital asset options), these are reported under rules generally applicable to options generally under existing option reporting rules.

(c) Regulated Futures Contracts and Section 1256 Options. Reporting for RFCs and section 1256 options on digital assets follow the general rules for regulated futures contract reporting (these are the aggregate gain/loss reporting provisions of Reg. 1.6045-1(c)(5)).

C. Exclusions for Exempt Foreign Persons and Sales Effected at Office Outside U.S.

Under the broker reporting regulations, for sales effected at an office outside the U.S., only a U.S. payor or U.S. middleman is treated as a broker. U.S. payors include U.S. persons as well as controlled foreign corporations (CFCs) but not other non-U.S. persons generally. Also, where the customer is an “exempt foreign person,” the customer is exempt from broker reporting under section 6045. The proposed regulations contain specific rules for digital assets to both determine when a sale is treated as effected at an office outside the U.S. and the requirements for valid documentation to support exempt foreign person status and the presumption rules applicable in the absence of such documentation or where such documentation is determined invalid.

The rules for each of these determinations depend on 1) where the digital asset broker is organized; 2) whether it is a CFC of a U.S. parent; 3) whether it is engaged in the money services business; 4) whether there are U.S. indicia with respect to customers in its account records; 5) the documentation or absence of documentation received from customers; and 6) whether there are conflicts between customer documentation and account records or other documentation.

These rules are nuanced and will require both U.S. and non-U.S. digital asset providers to review tax onboarding procedures and systems documentation validation processes within the context of their business structure.

D. Guidance for Taxpayers

The Treasury and IRS has provided new guidance for taxpayers with respect to determining the amount realized and cost basis in dispositions relating to digital assets. Of note, where a digital asset is exchanged for another digital asset different in kind, the transaction costs for the disposition is allocated 50/50 between the digital asset sold and the digital asset acquired. Thus, only 50% of the transaction cost reduces the gross proceeds in determining the amount realized. The other 50% is included in the basis of the digital asset acquired. This allocation of transaction costs from the sale to both the asset sold and the asset acquired may require special processing by systems that have already been developed for traditional securities sales.

The rules also provide lot relief methodology where a taxpayer disposes of some but not its entire position in a digital asset. In such case, the taxpayer can specifically identify the lots subject to a sale by maintaining adequate identification in its books and records by the time of the sale. Absent such identification, generally a FIFO methodology would be used.

This guidance is effective on January 1 following the calendar year that the regulations are published as final in the Federal Register.

E. Next Steps: Comments, Other Expected Guidance

Within the proposed regulations, the Treasury and the IRS have requested industry feedback on some 50 separate questions relating to the proposed provisions. The due date for submission of comments is October 30, 2023. A hearing on the comments and proposed regulations is scheduled for November 7 and 8, 2023. Given the extent of the questions, we would anticipate changes based on feedback received. This may be an opportune time for industry participants to voice concerns, especially implementation or data challenges, raised by the proposed regulations.

While these proposed regulations cover a number of broker information reporting areas, one significant area that is left open is the issue of transfers of digital assets into and out of custodial and non-custodial wallets. Due to this, the cost basis reporting in the current framework is limited. But separate guidance under Sections 6045A (on transfer reporting) and 6045B (organizational change reporting) is expected in the future and would likely impact the scope of what is subject to cost basis reporting.

Also, the Treasury and the IRS note in the preamble that when and if the U.S. accepts the OECD Crypto Asset Reporting Framework (CARF) for global tax information reporting and exchange for digital asset transactions, new guidance (e.g., impacting the exempt foreign person exception) may be issued to address data needs for CARF information exchanges.

We are in the process of preparing industry-specific write-ups (e.g., custodial brokers, decentralized exchanges, digital asset payment providers, NFT marketplaces) in future publications.

If you are interested in a specific industry write-up or have questions about the above, please contact:

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