

IRS Proposes New Regulations on Broker Reporting Digital Asset Transactions with Hidden Additional Guidance beyond Broker Reporting Part 1

by Philipp Behrendt

The year 2023 is witnessing transformative changes in the tax landscape for digital assets, with the Internal Revenue Service (IRS) poised to usher in a significant transformation. The official version of the proposed regulations for broker reporting under Code Secs. 6045 and 6045A is scheduled for August 29, 2023. However, ahead of this official release, the Treasury Department granted access to the 282 page unofficial proposed regulations ([Proposed Regulation 2023-17565](#)). These regulations outline the requirements for brokers mandated to report sales and exchanges of digital assets by their customers. This pivotal moment has been in the making since the enactment of the Infrastructure Investment and Jobs Act (P.L. 117-58) on November 15, 2021. Importantly, these regulations go beyond broker reporting; they provide comprehensive insights into how the IRS defines and views the world of digital assets, making them a valuable resource for tax professionals venturing into the cryptocurrency arena.

The genesis of these forthcoming regulations can be traced back to the Infrastructure Investment and Jobs Act, signed into law in November 2021. This law introduced substantial changes to the tax reporting landscape, particularly impacting digital assets. Among other things, it amended Code Sec. 6045 to include within its ambit brokers and other entities involved in the transfer of digital assets as persons required to file detailed reports about their customers. It also makes persons and entities involved in the transfer of digital assets subject to Code Sec. 6045A.

The Infrastructure Act outlined a plan to enforce mandatory broker reporting for digital asset transactions starting with tax returns due in 2023, contingent upon the issuance of comprehensive regulations. The reporting requirements remained pending, however, until the IRS provided the necessary regulatory guidance.

Now, after months of anticipation, these regulations are set to be officially released. If adopted, the regulations will fundamentally alter the reporting and taxation landscape for digital asset transactions, offering much-needed clarity and compliance to the cryptocurrency market. This blog will contain an overview of the proposed regulations and the mandatory reporting requirements that will be imposed on brokers of digital assets. Part 2 will discuss how the regulations impact the basis rules for digital assets.

I. Overview of Proposed Regulations

The proposed regulations encompass a wide range of changes and clarifications. Some of the most notable provisions include:

- **Expanding the Definition of "Broker"**: The proposed regulations extend the definition of a "broker" subject to Form 1099 reporting to include cryptocurrency exchanges, hosted wallet providers, payment processors, and any other intermediary that provides services facilitating the sale or exchange of digital assets. Decentralized protocols will require a case-by-case analysis.
- **Inclusion of NFTs and Stablecoin Issuers**: NFTs (Non-Fungible Tokens) are included in the reporting requirement, and stablecoin issuers are considered brokers.

- Reporting Adjusted Cost Basis: Brokers are required to report customers' adjusted cost basis, certified customer information, and lot-level transactional data.
- New Regulations for Determining Amount Realized and Basis: The proposed regulations outline new rules under Code Sections 1001 and 1012 for determining the amount realized and basis from sales, trades, and other dispositions of digital assets.
- Real Estate Transactions: Real estate brokers must disclose the fair market value (FMV) of any cryptocurrency received as part of a real estate transaction.
- Rules for Foreign Persons: Comprehensive regulations for foreign persons.
- Staged Implementation: The regulations are phased in over several tax years, starting with the tax year beginning on or after January 1, 2023, and continuing through 2026. This phased approach allows digital asset brokers and taxpayers time to adapt to the new reporting requirements. In particular:
 - Tax Years Beginning on or After January 1, 2023: Digital asset brokers are mandated to possess cost basis information. This marks the initiation of enhanced reporting requirements in the digital asset sphere.
 - Tax Years Beginning on or After January 1 of the Calendar Year Immediately Following the Date of Publication of the Final Regulations (Expected to be 2024 or 2025): In this phase, regulations concerning the computation of gains or losses and the basis of digital assets under Code Section 1001 and 1012 are expected to come into effect. These changes promise to provide a solid foundation for accurate tax calculations in the digital asset domain.
 - Tax Years Beginning on or After January 1, 2025: This milestone introduces a significant shift in reporting standards. Reporting will adhere to the rules of gross proceeds reporting, as outlined in proposed §1.6045-1. Certain exceptions apply, particularly regarding §1.6045-1(d)(2)(i)(C), adding nuances to this crucial year in digital asset taxation.
 - Real Estate Transactions with Dates Closing on or After January 1, 2025: For transactions involving real estate and digital asset payments, this year brings about an obligation to report these payments accurately.
 - Tax Years Beginning on or After January 1, 2026: The final phase in this timeline introduces comprehensive reporting standards. Digital asset reporting will now adhere to the rules of both gross proceeds reporting and adjusted cost basis reporting, as defined in proposed §1.6045-1, including -1(d)(2)(i)(C). This marks the full implementation of these regulations, offering a complete framework for tax compliance.

These changes bring long-awaited regulations for broker reporting for digital assets, but they also introduce complexities and challenges. Taxpayers, brokers, and investors will need to carefully navigate the evolving regulatory landscape to ensure compliance.

II. New Definitions and Form 1099-DA

The proposed regulations cover a broad range of digital asset issues, including clarifying the definition of “broker” and necessitating the reporting of proceeds to the IRS on a new form, Form 1099-DA.

According to the proposed regulations, brokers are defined as those who, in the ordinary course of their trade or business, act as agents, principals, or digital asset middlemen to effect sales or exchanges of digital assets for cash, broker services, or property. The definition includes digital asset trading platforms, digital asset payment processors, certain digital asset hosted wallet providers, and persons who regularly offer to redeem digital assets that they have created or issued.

Excluded are persons that do not act as a principal in the sale as a dealer of digital assets on behalf of others. This excludes, for example, retailers accepting digital assets as payments or NFT creators selling their work (see p. 44).

The proposed regulations contain many new or expanded definitions and rules. The Proposed Regulations explain that under the current view, the definition of “digital assets” includes NFTs, and consequently also the reporting requirement extent to NFT transactions and stablecoins. However, the term “digital assets” does not include virtual assets that exist only in closed systems, such as video game tokens, and also does not extend to distributed ledger technologies (“DLT”) that do not create new transferable assets, such as DLTs for tracking inventory or processing orders.

If the proposed regulations become final, they will have considerable implications in the digital or crypto space. For instance, the expanded definition of brokers would mean that an increased number of entities would now be obligated to report their transactions to the IRS.

Brokers will use the Form 1099-DA to report proceeds from the sale and exchange of digital assets. The inclusion of this form provides a formal, standardized method for reporting these transactions, giving brokers initial guideline to follow.

III. Mandatory Basis Reporting

Currently, brokers and financial institutions must report the adjusted basis of certain financial assets to the IRS. Brokers of digital assets will have to report the tax basis for digital assets in the future if the proposed regulations become final.

The regulations establish a clear distinction between custodial and non-custodial brokers concerning mandatory basis reporting. Custodial brokers, who hold and sell digital assets on behalf of customers, are primarily responsible for reporting tax basis information for digital assets acquired and held in a customer's account. Not subject to the mandatory basis reporting rules are sale transactions that were not previously acquired in the customer's account or sale transactions effected by non-custodial brokers. Non-custodial brokers are understood as brokers that do not have access to the private key. This differentiation recognizes the need for comprehensive tracking and reporting in complex digital asset transactions.

The regulations set the "acquisition applicable date" for digital assets at January 1, 2023, marking the point at which brokers must begin tracking and reporting tax basis information for digital assets in customer accounts. Brokers have the option to voluntarily report this information before the regulations' applicable dates without penalties for failure to report or furnish that information correctly. Additionally, the regulations reserve provisions for implementing safe harbor exceptions for minor errors in information returns and payee statements. These exceptions will provide relief for minor reporting inaccuracies, contributing to more manageable compliance.

IV. An Unorganized Group of Persons as a Broker

The regulations contain provisions that may prove controversial, including the provisions on the “person” who qualify as a broker.

The explanatory section of the proposed regulation explains on page 37 that the term “person” includes a business entity that is treated as an association or a partnership for Federal tax purposes under §301.7701-3(b). Whether a group of persons is a broker is not contingent on whether the group operates through a legal entity. As long as a group provides facilitative services and “are in a position to know the customer’s identity and the nature of the transaction effectuated by customers” the group may be treated as a broker, according to the Proposed Regulations (p. 37). Potentially, this could extend the broker definition to even truly decentralized protocols, meaning a set of rules and standards that enable distributed networks to function without central authorities, relying on peer-to-peer communication and consensus mechanisms.

Without having a central authority that can manage and oversee the reporting, these reporting requirements will pose a unique challenge for decentralized protocols. This kind of challenge is nothing new for the – currently still very rare – decentralized networks, as the implementation of “Know Your Customer” (“KYC”) has proven. Decentralized protocols can maintain their decentralized nature while complying with KYC and similar regulations by implementing mechanisms that allow trusted third parties, such as identity providers, to conduct KYC checks and verify the identity of crypto wallet holders. On the other hand, broker reporting requirements under Section 6045 pose a different challenge for decentralized protocols, as they may involve reporting transactions to authorities, which could be difficult to implement without compromising the protocol's decentralized nature.

V. Expect More Changes

The Treasury Department and the IRS anticipate making further changes to the broker reporting requirements for digital assets in multiple phases. These later phase changes will expand on existing regulations, focusing on implementing transfer statement reporting under section 6045A(a) and broker information reporting under section 6045A(d) for covered security transfers that are not transfers to accounts maintained by persons known to be brokers or are not subject to reporting as sales, according to the Proposed Regulations.

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