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Report No. 1483
November 13, 2023

The Honorable Lily Batchelder
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Daniel I. Werfel
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Principal Deputy Chief Counsel
and Deputy Chief Counsel
(Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Report No. 1483 - Report on Proposed Regulations Concerning Information Reporting for Digital Asset Transactions

Dear Ms. Batchelder and Messrs. Werfel and Paul:

 I am pleased to submit Report No. 1483 of the Tax Section of the New York State Bar Association, which discusses proposed regulations concerning information reporting for digital asset transactions.

 We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Philip Wagman

Philip Wagman
Chair

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Report No. 1483

New York State Bar Association Tax Section

Report on Proposed Regulations Concerning Information Reporting
for Digital Asset Transactions

November 13, 2023

Table of Contents

**Report on Proposed Regulations Concerning Information Reporting
for Digital Asset Transactions**

I.   Introduction

This report (the "**Report**") comments on the proposed regulations published by the United States Department of the Treasury ("**Treasury**" including, as applicable, the Internal Revenue Service (the "**IRS**")) on August 29, 2023 (the "**Proposed Regulations**") regarding information reporting, the determination of amount realized and basis, and backup withholding for certain digital asset sales and exchanges.[1] We commend Treasury for its significant and ongoing efforts to provide guidance regarding the tax treatment and reporting of digital asset transactions. We understand that Treasury intends to issue final regulations (the "**Final Regulations**") that reflect public comments on the Proposed Regulations. We have therefore collected factual information regarding the structure of digital asset markets from various industry participants, in order to better understand the technical operations of digital asset networks and assess how best to attain the goal of achieving comprehensive information reporting within the framework of the current and evolving world of digital asset networks and markets.[2] Based on the information we have gathered, as well as our own understanding of the principal challenges faced by industry participants, this Report focuses on four main areas of comment: (i) the definition of "broker," (ii) the application of information reporting requirements to decentralized exchanges ("**DEXs**"), (iii) the application of information reporting requirements to stablecoin transactions, and (iv) the scope of a "disposition."[3] We also provide limited comments on certain aspects of backup withholding. This Report highlights certain technical aspects of digital asset networks and market operations, requests that Treasury clarify the scope of certain definitions and suggests certain factors Treasury may wish to consider in building a legal framework for digital asset transaction reporting and backup withholding.

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[1] The principal drafters of this Report were Eschi Rahimi-Laridjani and Elena Romanova with helpful comments from Peter Benesch, Garrett Brodeur, Lani Chou, Peter Connors, Cyrus Daftary, Lucy Farr, Tara Ferris, Philip Garlett, Jonathan Gifford, Lorenz Haselberger, Jonathan Jackel, Jiyeon Lim-Lee, Lauren Lovelace, John Lutz, Michael Meisler, Richard Nugent, Arvind Ravichandran, Jason Sacks, Michael Schler, Philip Wagman, Andrew Walker and Libin Zhang. Significant contributions were made by Yucai (Michael) Yu and Anne-Sophie Tomé. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of NYSBA's Executive Committee or its House of Delegates.

[2] While we have spoken with industry participants to gather factual information and have attempted to reflect in this Report our resulting understanding of how the current digital asset ecosystem operates, we recognize that there may be disagreement about certain factual aspects of digital asset networks and markets. Moreover, this is an evolving space where many aspects of operations can and do change rapidly.

[3] The Proposed Regulations represent the impressive result of Treasury's immense effort at providing comprehensive guidance. The Proposed Regulations, while focusing on information reporting matters and generally reserving on substantive analysis and positions, may implicate a number of substantive areas of the tax law, as well as areas of information reporting relating to non-digital assets. We have focused on the particular areas where we believe our comments can provide the most helpful contributions to developing information reporting rules for digital asset transactions, rather than taking an all-encompassing approach to commenting on the Proposed Regulations that would address these additional, broader issues.

II. Background

A. Decentralized Exchanges

As background to our comments on the Proposed Regulations, we believe it would be helpful to summarize the operation of digital asset markets, including the decentralized finance ("**DeFi**") industry and DEXs[4] in particular, and introduce certain concepts we reference throughout this Report. We previously commented on certain substantive aspects of taxation of digital assets in reports submitted in 2020[5], 2022[6] and 2023[7]. We refer to those reports for a background discussion of certain basic aspects of cryptocurrency, other fungible digital assets, non-fungible tokens ("**NFTs**"), crypto wallets and certain exchanges that may be necessary for understanding the workings of DEXs that we discuss below.

Unlike traditional financial assets such as stock and debt instruments, digital assets can be held and traded directly by individuals or entities on a large scale without the involvement of traditional intermediaries such as banks or brokers. Owners of digital assets can custody those assets directly in an electronic wallet that they control. Digital assets can also be traded peer-to-peer without the involvement of an intermediary through DeFi platforms such as DEXs. The resulting disintermediation gives rise to an ecosystem that differs fundamentally from the intermediated system that is predominant in the custody and trading of traditional financial assets.

As a general matter, centralized cryptocurrency and digital assets exchanges ("**CEXs**") operate broadly like traditional stock exchanges. Buyers and sellers are matched by the exchange on a one-to-one basis through orders (via an "order book"). When a buyer's bid matches the seller's ask, a trade occurs. Although the matching is done by the CEX and the trade cannot happen without the CEX, the trade happens between the buyer and the seller, intermediated by the exchange. A CEX can handle trades in digital assets and fiat currency and serve as an "on-ramp" into digital assets or an "off-ramp" into fiat currency for market participants through its relationships with conventional banks. The transactions on a CEX generally are not recorded directly on a blockchain, but rather on the CEX's internal register or ledger that tracks each customer's holdings and transactions, and may be recorded by the CEX to the blockchain collectively on a regular basis.

By contrast, a DEX is a set of self-executing software programs or "smart contracts"[8] pursuant to which, although there is a perception of peer-to-peer trading, buyers and sellers

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[4] DEXs are only a subset of various DeFi protocols, which range in function and are not limited to trading digital assets. There are DeFi protocols that move assets from one blockchain network to another (*e.g.*, Connext Protocol), allow decentralized lending or liquidity markets (AAVE and Compound), and many other types.

[5] New York State Bar Association Tax Section, *Report on the Taxation of Cryptocurrency* (Jan. 26, 2020) (the "**2020 Report**").

[6] New York State Bar Association Tax Section, *Report on Cryptocurrency and Other Fungible Digital Assets* (April 18, 2022)) (the "**2022 Report**").

[7] New York State Bar Association Tax Section, *Report on Notice 2023-27 and Nonfungible Tokens (NFTs)* (June 18, 2023)) (the "**2023 Report**").

[8] A smart contract is a self-executing software program that delivers a prespecified irreversible output based on objectively verifiable input, without any need for human intervention. While in most instances, a smart contract works

generally do not transact with each other. Instead, buyers and sellers transacting through DEXs often interact with a "liquidity pool." A "liquidity pool" is a "smart contract" used by a common type of DEX called an "automated market maker" that accepts and locks up pairs of digital tokens contributed by "liquidity providers" in exchange for "liquidity tokens." In the most common case, each pair of digital tokens consists of one cryptocurrency (e.g., bitcoin, ETH) and one sponsored or algorithmic stablecoin (e.g., USDC or DAI),[9] although pairs of stablecoins or pairs of cryptocurrencies, or pairs of other digital assets also are possible and do exist.[10] The liquidity pool generally sets the product of the number of the two tokens to be constant (although we understand that more complicated formulas may exist), which changes the relative value of tokens as their numbers fluctuate due to trades or when the liquidity providers "cash out" or "burn" their liquidity tokens.

The rules for trading between buyers and sellers and a liquidity pool is generally governed by a software protocol. The DEX transactions are recorded directly on the blockchain. The prices of the pairs of digital assets in an automated market maker DEX are established algorithmically based on the application of the constant product formula to the relative number of tokens in the pool as described above after any given trade. The fees for transacting with the pool (which generally accrue to the liquidity providers) are often hardwired into the protocol or can be set by either governance token-holders or by the creator of the liquidity pool. In addition to the fees charged by a DEX, anyone transacting on the Ethereum blockchain is required to pay separate fees (i.e., gas).[11]

A DEX does not custody the assets of transacting parties. These assets are usually stored in the transactors' wallets until they are traded.[12] A DEX does not have a customer relationship with anyone interacting with any pool.[13] In addition, the DEX (the underlying exchange protocol) is separate and distinct from an interface (often referred to as a "front-end") that may facilitate a more user-friendly method of interacting with the DEX. Navigating a DEX directly without an interface is possible, but is cumbersome and requires specialized knowledge that most market participants do not possess. Interfaces can be provided by communities associated with a DEX or by wallet providers and may differ in their ease of use and in other features. Several interfaces may be offered by many unrelated providers to access the same DEX. Usually, market participants can connect to the interface of a particular DEX either through a web browser or through a crypto wallet. In a standard transaction effected on a DEX, a market participant generally may be expected to use a crypto wallet to execute the transaction on the DEX. Each of the crypto wallet, the interface

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as intended, not all events, human interventions or contingencies are anticipated by the software writers and provided for in the program, leaving a potential for dispute or perceived misfunction. *See* the 2022 Report, p. 11.

[9] *See* description of stablecoins in the 2022 Report, pp. 2 and 33-35.

[10] UNISWAP, "*Top Pairs*", https://v2.info.uniswap.org/pairs.

[11] The most popular DEXs — like Uniswap and Sushiswap — utilize the Ethereum blockchain.

[12] Wallets are generally discussed in the 2020 Report, p. 3.

[13] A liquidity pool does contain asset pairs, but those do not belong to customers. Once a liquidity provider exchanges its pair of tokens for a liquidity provider ("**LP**") token in a liquidity pool, the original tokens leave the liquidity provider's wallet and are replaced by the LP tokens. The original tokens are then locked in a smart contract subject to the code of the liquidity pool and the DEX and are not in the control of any person or entity, unless and until the liquidity provider burns its LP tokens to get back a share of the pool's pair of tokens, based on a new ratio.

and the DEX would generally be a separate function fulfilled by a separate protocol or software application. DEXs do not offer direct off-ramps to fiat currency and a party transacting via a DEX needs to utilize a CEX or another digital asset service provider in order to convert digital assets traded on a DEX into fiat currency.

A particular trading protocol may be written as open-source and available to anyone to be incorporated into or used as a building block for other protocols. Some trading protocols are written as immutable and cannot be changed. Some trading protocols may be subject to alteration under various governance structures. In certain instances, governance of protocols or parts of the protocols is implemented through governance tokens, which must vote with respect to any changes, and which may be held pseudonymously. The group of governance token-holders that control or govern aspects of the DEX are commonly referred to as a decentralized autonomous organization ("**DAO**"). DAO participants may be allocated and receive governance tokens in a variety of ways. Generally, each governance token carries one vote. In order to change functionality, a proposal needs to be formulated, new code must be written, and then the token-holders vote on whether to implement such proposal and code.

Once a required level of consensus is reached, the governance decisions are embodied in the protocol's smart contracts, which execute decisions automatically when the given conditions in the smart contracts program are met. The smart contracts can thus be changed by a pre-determined number of votes of the DAO token-holders. Governance tokens may be held widely or may be concentrated in the hands of a few persons that can effectively control the protocol.

Under current legal frameworks, a DAO generally is believed not to constitute a legal entity under local law, although some DAOs may organize foundations that promote causes generally associated with the related DAO. As a general matter, it may be difficult to identify a particular individual or group of individuals that may represent a DAO or interact with the non-digital world on its behalf.

B. **Certain Streamlined Regimes that Facilitate Tax Information Reporting under Current Law**

Tax information reporting offers important advantages to both taxpayers and the government. It promotes tax compliance by providing taxpayers with the information necessary to report accurately and meet their tax obligations. Information reporting also eases tax administration by reducing audit and enforcement costs borne by the government. The current information reporting requirements predominantly rely on intermediaries to report tax information to both taxpayers and the IRS, and this approach generally has worked well in heavily intermediated areas like traditional finance and employment. While CEXs in many ways resemble traditional financial institutions and brokers, DEXs present varying degrees of decentralization. In general, the more decentralized a platform is and the more varied the access points to the platform are, the more difficult it will be to identify a single point of responsibility for implementing reporting compliance as opposed to having multiple parties with reporting requirements, resulting in potentially duplicative reporting.

Treasury has faced difficulties in the past in ensuring that appropriate reporting mechanisms are in place, including in connection with cross-border payment flows, and has

addressed the challenges by creating systems in which certain entities with the relevant wherewithal can assume withholding and reporting responsibilities in a coordinated fashion, while largely alleviating compliance burdens imposed on the remainder of the system. We will briefly describe two such regimes because we believe that they may serve as helpful guideposts in constructing an effective information reporting and backup withholding regime for digital asset transactions.

The "qualified intermediary" ("**QI**") regime facilitates compliance with certain documentation collection, withholding and information reporting obligations imposed on payors by allowing them to fulfill their own responsibilities with respect to payments made to non-U.S. persons by receiving certifications from a QI payee who accepts payments on behalf of the ultimate beneficial owners. A QI is generally a foreign financial institution that signs an agreement with the IRS, maintains its own records of the U.S. or foreign status of the beneficial owners of the payments and often undertakes responsibility for income reporting and tax withholding.[14] If certain requirements are met, a QI is not required to disclose to any payor the identifying information about its own customers, on whose behalf the QI receives the income.[15] A QI is subject to periodic audit by the IRS or external auditors to confirm compliance with the terms of the QI agreement.[16] A QI is a payor for purposes of IRS Form 1099 reporting under chapter 61 and backup withholding under Section 3406[17] for broker proceeds that it pays to U.S. non-exempt recipients. Moreover, a QI is responsible for IRS Form 1099-B reporting and backup withholding on broker proceeds whether or not the QI assumes primary IRS Form 1099 reporting and backup withholding responsibility with respect to payments other than broker proceeds. However, a QI generally is not required to backup withhold on broker proceeds if the proceeds are from a sale effected outside of the United States unless the broker has actual knowledge that the payee is a U.S. person.[18]

Employment related reporting and withholding is another area in which the IRS has created a regime to simplify and streamline certain responsibilities. Employers can contract with a professional employer organization ("**PEO**") to administer payroll, withholding, tax deposit, and other functions. Under Section 3511(a)(1), if a PEO becomes certified under IRS rules, the certified PEO ("**CPEO**") is considered to be the sole employer for purposes of payroll taxes and bears sole responsibility for payroll taxes. To be certified, a PEO must satisfy various requirements intended to ensure that the PEO properly remits wages and employment taxes, including requirements related to (1) reporting obligations, (2) posting a bond in case the PEO fails to satisfy its employment tax withholding and payment obligations, (3) computing taxable income using an accrual method of accounting unless another method is approved by Treasury, and (4) submitting

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[14] *See* Treas. Reg. § 1.1441-1(e)(5). Depending on whether a payor makes a payment to a QI that undertakes income reporting and tax withholding responsibilities, the payor's own obligations may or may not be shifted to the institution receiving payment, thereby ensuring that there is always a payor that remains liable for such withholding and reporting obligations.

[15] Rev. Proc. 2022-43, Section 6.01 of the 2023 Qualified Intermediary Agreement.

[16] *Id.*, Sections 10.04 – 10.08 of the 2023 Qualified Intermediary Agreement.

[17] All section and chapter references herein are to the Internal Revenue Code of 1986, as amended (the "**Code**") or to the Treasury regulations promulgated thereunder, unless otherwise indicated.

[18] *See* Treas. Regs. §§ 31.3406(g)-1(e).

audited financial statements.[19] For many employers, contracting with a CPEO is a cost efficient and low risk way of satisfying payroll tax related responsibilities.

C.   Backup Withholding Rules

The current information reporting rules enforce the obligations to report and self-assess tax on income otherwise reported by a financial institution by requiring backup withholding on undocumented payees or payees that have previously failed to report certain income. Backup withholding with respect to broker proceeds from the sale of a security is subject to a separate set of rules than backup withholding on interest and dividends.[20] A broker is a payor for purposes of IRS Form 1099 reporting under chapter 61 and backup withholding under Section 3406 for broker proceeds that it pays to U.S. non-exempt recipients. For this purpose, "broker proceeds" means gross proceeds from a sale or other disposition that is reportable under Treasury Regulations section 1.6045-1(c). IRS Form 1099-B reporting generally is enforced by the backup withholding regime and Sections 6721 (failure to correct information returns) and 6722 (failure to furnish correct payee statements). Because "sale" for these purposes requires a disposition "conducted for cash," the broker will hold cash from which it can withhold the required amounts.[21]

The existing backup withholding regime requires certain payors to backup withhold at the statutory rate of 24% on the amount of gross proceeds required to be reported under Section 6045 and on IRS Form 1099-B if the payee fails to certify its taxpayer identification number ("**TIN**") on IRS Form W-9 or provides an incorrect TIN.[22] A payor may use the IRS TIN Matching Service to verify that the TIN and name combination provided by the payee is correct. Backup withholding may also be required where the IRS notifies a payor that the TIN furnished by the payee is incorrect.

Certain payees are exempt from backup withholding, including U.S. exempt recipients and non-U.S. persons who provide an IRS Form W-8 (or applicable documentary evidence when permitted in lieu of an IRS Form W-8) to substantiate status as a non-U.S. person. In order to report backup withholding, a payor files a tax return with the IRS on IRS Form 945, Annual Return of Withheld Federal Income Tax, and reports the amount of backup withholding and the amount of the payment on Form 1099-B, Proceeds from Broker and Barter Exchanges (filed with the IRS and furnished to the payee).

Where the IRS Form 1099-B includes an incorrect name and TIN combination, the IRS will furnish a "B" notice that informs the payor of the mismatch. The payor must promptly furnish the "B" notice and an IRS Form W-9 to the payee. If the payor receives two incorrect TIN notices within three years for the same account, it must furnish a second "B" notice informing the payee that it will be subject to backup withholding unless the payor receives verification of the payee's

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[19] *See* I.R.C. § 7705(b), (c); Treas. Reg. § 301.7705-2.

[20] Treas. Regs. §§ 31.3406(b)(2)-1 (interest payments), 31.3406(b)(2)-4 (dividends), 31.3406(b)(3)-2 (gross proceeds of sale of securities or commodities by brokers).

[21] Treas. Reg. § 1.6045-1(a)(9).

[22] *See* I.R.C. § 3406; Treas. Reg. § 31.3406(a)-1(b)(1).

TIN – in the form of either a copy of the payee's Social Security Card or an IRS Letter 147C validating the payee's employer identification number.[23]

III. Summary of Certain Aspects of the Proposed Regulations

Among other things, the Proposed Regulations expand the scope of Section 6045 to require information reporting by "brokers" of digital assets transactions (including transactions involving stablecoins[24]) in which digital assets are exchanged for cash, other digital assets, stored-value cards, broker services or other property, thereby disapplying the "conducted for cash" requirement applicable to dispositions of securities.[25] The Proposed Regulations also expand the current definition of "broker" to include "persons" (within the meaning of Treas. Reg. Section 301.7701-3(b)) that, in the ordinary course of their trade or business, act as agents, principals or "digital asset middlemen" in transactions involving the sale or exchange of digital assets,[26] and clarify that, for purposes of Section 6045, digital asset trading platforms, digital asset payment processors, certain digital asset hosted wallet providers and persons who regularly offer to redeem digital assets that such person has created or issued are considered to be brokers.[27]

The Proposed Regulations further revise the current definition of "effect" under existing Treasury Regulations section 1.6045-1(a)(10) to provide that any person providing "facilitative services" to effect the sale of digital assets for customers is a broker, if the nature of the services provided by such person is such that the person would ordinarily know or be in a position to know the "identity of the party [making] the sale and the nature of the transaction potentially giving rise to gross proceeds."[28] A person is in a position to know the identity of a party making a sale if that person maintains "sufficient control or influence over the facilitative services provided" such that it is able to set or change the terms of service to require the seller to provide their name, address and TIN prior to the sale.[29] The Proposed Regulations explicitly exclude ledger validators and certain hardware and licensing software providers from the category of persons that are "brokers" as a result of providing "facilitative services" given that such persons may not be in a position to know a seller's identity or the nature of any given transaction,[30] but capture certain DeFi industry participants, such as interfaces.[31]

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[23] *See* Treas. Reg. § 31.3406(d)-5(g) and IRS Publication 1281, Backup Withholding for Missing and Incorrect TINs.

[24] *See* Part I.K of the preamble to the Proposed Regulations (the "**Preamble**"), 88 Fed. Reg. 59576, 59608 (August 29, 2023).

[25] Prop. Treas. Reg. § 1.6045-1(a)(9).

[26] Prop. Treas. Reg. § 1.6045-1(a)(1), (10), (21).

[27] *See* Part D.1.b. of the Special Analyses in the Preamble, 88 Fed. Reg. at 59618.

[28] Prop. Treas. Reg. § 1.6045-1(a)(21)(i), (ii),.

[29] Prop. Treas. Reg. § 1.6045-1(a)(21)(ii).

[30] Prop. Treas. Reg. § 1.6045-1(a)(21)(iii)(A).

[31] See Part I.B of the Preamble, 88 Fed. Reg. at 59586.

IV.   Summary of Recommendations

1.   Treasury should create a "qualified digital asset reporting person" ("**QDARP**") regime partially modeled after the existing regimes that streamline information reporting and withholding in the cross-border payment and employment contexts.

2.   Treasury should clarify the scope of the exclusion from the definition of "broker" for certain validators and certain software and hardware providers.

3.   Treasury should consider providing a *de minimis* threshold for the number and/or value of transactions facilitated before penalties for the failure to comply with the information reporting requirements apply during a start-up or transitional period. Alternatively, or potentially in addition to such a temporary *de minimis* threshold, Treasury should consider providing a grace period during which an industry participant can either come into compliance (including potentially by contracting with a QDARP) or adjust its activities so as to avoid qualifying as a broker, without immediately facing penalties for failure to report.

4.   The Final Regulations should explicitly permit utilizing the IRS TIN Matching Program for digital asset reporting in order to minimize the incidence of backup withholding. We further recommend that Treasury continue to study how backup withholding can be applied where dispositions of digital assets are not for cash.

5.   The Final Regulations should clarify that currently existing DEXs using immutable protocols do not themselves qualify as "brokers." In addition, the Final Regulations should provide examples applying the "reason to know" standard to certain currently existing DEXs with distributed governance structures that may be practically unable to modify their existing protocols to collect the required tax-related information, despite the fact that such modifications are theoretically possible if a sufficient number of governance token-holders were to come together to vote in concert. Such examples should clarify that interfaces connecting to DEXs using immutable protocols are required to report or contract with a QDARP.

6.   Treasury should permit the creation of identity/privacy tokens that can store taxpayer identifying information, including substitute IRS Forms W-9 and W-8, and be used across platforms and by QDARPs to reconcile and report information.

7.   Treasury should consider an exemption from information reporting for proceeds from disposing of a "specified stablecoin" (as defined in Part VII.A) that would generally be similar to the exemption for a sale of shares of a domestic money market fund, where the stablecoin is only held for a short period.

8.   Treasury should clarify whether transfers of digital assets in connection with digital asset lending transactions are subject to information reporting in the absence of guidance on the substantive tax treatment of such lending transactions.

9.   Treasury should address whether staking of digital assets is subject to information reporting.

10.   Treasury should explicitly reserve on information reporting with respect to wrapping and unwrapping coins and tokens until substantive guidance on the tax treatment of these transactions is issued, in cases where the sole purpose of wrapping such coins and tokens is to make them usable in a transaction that is itself subject to information reporting.

V.   Definition of "Broker"

A.   Broad Definition for Digital Asset Transactions

"Brokers" historically have been required to report sales of securities and commodities on IRS Form 1099-B.[32] Current Treasury regulations provide for essentially two types of brokers. The first, which covers most brokers, includes any person who, "in the ordinary course of a trade or business during the calendar year, stands ready to effect sales to be made by others."[33] The second covers an issuer of securities who "regularly" issues and redeems its own stock or debt.[34] Brokers are required to obtain from customers IRS Form W-9, "Request for Taxpayer Identification Number and Certification," or establish that the customer is either an exempt recipient or a foreign person not subject to IRS Form 1099-B reporting.[35] A broker who effects a reportable sale in the United States for a customer who has not provided an IRS Form W-9 and who has not been shown to be exempt from IRS Form 1099-B reporting is required to "backup withhold" on the gross proceeds of the sale at a rate of 24%.[36]

Because there could be multiple persons that meet the definition of broker in a securities sale transaction, current Treasury regulations provide relief to avoid duplicative reporting, which could lead to confusion for both the IRS (when trying to match IRS Forms 1099 to U.S. tax returns) and taxpayers (who would otherwise get multiple IRS Forms 1099 reporting the same sale transaction).[37] The multiple broker rule essentially requires the broker nearest to the customer, who is in the best position to collect customer information and who is most interested in providing the customer with cost basis information from a service perspective, to report.[38]

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[32] I.R.C. §§ 1.6045(a), (g); *see* IRS, "*About Form 1099-B, Proceeds from Broker and Barter Exchange Transactions*", https://www.irs.gov/forms-pubs/about-form-1099-b; *see also* Joint Committee on Taxation Staff Description of The Technical Corrections Act of 1988 (JCS-10-88) (H.R. 4333 and S. 2238), dated March 31, 1988 ("Persons doing business as a broker must report on specified types of transactions they effect for customers. Generally, reporting is required on sales of securities, commodities, regulated futures contracts, precious metals, and real estate.").

[33] Treas. Reg. § 1.6045-1(a)(1).

[34] *Id*.

[35] Treas. Reg. § 1.6045-1(d); IRS, "*Instructions for Form 1099-B (2023)*", https://www.irs.gov/instructions/i1099b.

[36] *See* Treas. Reg. §§ 31.3406(a)-1(b)(1), 31.3406(d)-1, 31.3406(h)-3.

[37] Treas. Reg. § 1.6045-1(c)(3)(iii).

[38] *Id*. Congress dealt with a similar issue in the context of real estate transactions, when the Tax Reform Act of 1986 was adopted. *See* General Explanation of the Tax Reform Act of 1986, Staff of Joint Committee on Taxation, 100th Cong., 1st Sess., at 1282-83 (May 4, 1987):

> The Act requires that real estate transactions be reported. The Act provides that the primary responsibility for reporting is on the person responsible for closing the transaction, including any title company or attorney who closes the transaction. This is generally the person conducting the

Under current Treasury Regulations, brokers are required to report sales "for cash."[39] Historically, brokers reported only the gross proceeds of a sale. Beginning with stock acquired in 2011, brokers became responsible for tracking and adjusting the cost basis of customers' positions, as well as the holding periods of those positions, and reporting that adjusted basis and holding period on IRS Form 1099-B.[40] The cost basis rules were phased in, starting with stock ineligible for basis averaging in 2011[41], then average basis stock in 2012[42], simple debt instruments in 2014[43], and finally complex debt instruments in 2016[44]. To effectively implement the reporting of cost basis when a security position is transferred to another broker, the sending broker is generally required to provide the receiving broker the adjusted basis and holding period information for that position if it is a covered security.[45] If the receiving broker does not receive a transfer statement, it is required to request one; if it still does not receive a transfer statement, the receiving broker is permitted to treat the securities as noncovered, meaning that basis and holding period information is not required to be reported upon a sale.[46]

The Infrastructure Investment and Jobs Act revised the definition of broker in Section 6045(c) of the Code to include "any person who, for consideration, is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person."[47] As noted above, based on this statutory language, the Proposed Regulations revise the definition of "effect" under existing Regulations to provide that any person that provides facilitative services that effectuate sales of digital assets by customers (a "digital asset middleman") will be considered a broker, provided the nature of the person's service arrangement with customers is such 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.[48] The Proposed Regulations specify that a person is in a "position to know" the

settlement. Treasury may issue regulations specifying who is the person responsible for closing the transaction, because it may not be clear which of several persons is the one responsible for closing the transaction. These regulations need not rely upon the presence or absence of a legal obligation at closing. Thus, Treasury may provide uniform rules to determine which of the persons involved with the closing is the one with primary responsibility for the information reporting.

If there is no person responsible for closing the transaction, the reporting must be done by the mortgage lender. If there is no mortgage lender, the reporting must be done by the seller's broker. If there is no seller's broker, the reporting must be done by the buyer's broker. If there is no buyer's broker, the reporting is to be done in accordance with regulations to be prescribed by the Secretary.

[39] Treas. Reg. § 1.6045-1(a)(9).

[40] I.R.C. § 6045(g)(2), (3)(C)(i).

[41] Treas. Reg. § 1.6045-1(a)(15)(i)(A).

[42] Treas. Reg. § 1.6045-1(a)(15)(i)(B).

[43] Treas. Reg. § 1.6045-1(a)(15)(i)(C); IRS Notice 2012-34.

[44] Treas. Reg. §§ 1.6045-1(a)(15)(i)(D), (n)(3).

[45] I.R.C. § 6045A; Treas. Reg. §1.6045A-1(b).

[46] Treas. Reg. § 1.6045A-1(b)(12)(i).

[47] Infrastructure Investment and Jobs Act, 23 U.S.C. § 80603(a).

[48] Prop. Treas. Reg. § 1.6045-1(a)(21)(i). Some stakeholders have attempted to raise the question of whether the statute supports this expansion of the definition of "broker." They have argued that the definition of "broker," as

identity of the party that makes the sale if "that person maintains sufficient control or influence over the facilitative services provided" to have the ability to set or change the terms of the service to request that the party making the sale provide that party's name, address, and TIN upon request.[49] A person ordinarily would also be in a position to know the nature of the transaction potentially giving rise to gross proceeds if such information is available, including by reference to the consideration received by the person providing the services.[50] In both cases, the ability to "change the fees charged for facilitative services" would result in a person having sufficient control or influence over facilitative services to be in a position to know the identity of the applicable party and the nature of the transaction.[51] Importantly, the term "person" under the Proposed Regulations includes a business entity that is treated as an association or a partnership for federal tax purposes under Treas. Reg. Section 301.7701-3(b), without the need for a legal entity to exist.[52]

As noted in our 2020 Report, we support the development of a robust information reporting regime to facilitate tax compliance among taxpayers who transact in digital assets.[53] Given the complexity of many digital asset transactions and the wide range of market participants from CEXs that operate virtually identically to stock exchanges and/or traditional securities brokers to immutable protocols running autonomously on blockchain, we understand the need to expand the scope of reportable "customer" transactions to include those carried out in whole or in part by a "digital asset middleman." However, the broad definition of "facilitative service", which includes "the provision of a service that directly or indirectly effectuates a sale of digital assets, such as providing a party in the sale access to an automatically executing contract or protocol, providing access to digital asset trading platforms, providing an automated market maker system, providing order matching services, providing market making functions, providing services to discover the most competitive buy and sell prices, or provide escrow or escrow-like services"[54] means that there may be multiple digital asset middlemen touching any given transaction. Furthermore, even when

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originally enacted by Congress, was intended to capture primarily the financial services context and that the Proposed Regulations are overly broad because they expand the definition of "broker" to non-financial contexts, which is not consistent with the commonly understood definition of a "broker." Supporters of this argument have asked whether the expansion of the scope of Section 6045 to include "digital assets" should be read within the confines of Section 6045 as originally enacted as a whole and not extended to cover non-financial use cases (*e.g.,* transfer of NFTs or personal consumption tokens). While one might conceivably seek to assert this is the correct reading of the statute, the argument appears to us to be a challenging one. The amendment of Section 6045 to include a new asset class, which is broadly enough drafted to include (for example) NFTs, see 2023 Report at pp. 26–28, and the simultaneous amendment of the definition of "broker," can reasonably be seen as supporting a policy of defining "broker" widely enough to cover persons with respect to this new asset class who perform functions analogous to those of traditional brokers.

Treasury has explained reasons for including NFTs in the definition of digital asset in the preamble to the Proposed Regulations. Part I.A.1 of the Preamble, 88 Fed. Reg. at 59581-82 (citing the rising popularity of purchasing NFTs as speculative investments or for use in payment transactions and the fact that, unlike trading cards or physical artwork, NFTs are easily and readily transferable to private wallets or offshore accounts).

[49] Prop. Treas. Reg. § 1.6045-1(a)(21)(ii)(A).

[50] Prop. Treas. Reg. § 1.6045-1(a)(21)(ii)(B).

[51] Prop. Treas. Reg. § 1.6045-1(a)(21)(ii)(A), (B).

[52] *See* Part I.B of the Preamble, 88 Fed. Reg. at 59588.

[53] *See* the 2020 Report, pp. 30-32.

[54] Prop. Treas. Reg. § 1.6045-1(a)(21)(iii).

a person's principal business does not meet the definition of broker, the person will be considered a broker if that person also regularly stands ready to effect sales of digital assets on behalf of customers, thus potentially covering hosted wallet providers and persons who sell or license software to unhosted wallet users.[55]

Under the Proposed Regulations, the broad definition of "digital asset middleman" can often require multiple "brokers" to report what is ultimately a single transaction and at least some of these "brokers" would have insufficient information to complete full information reporting. The existing Section 6045 Regulations do not present a similar concern with respect to securities reporting, because the reporting obligation is generally imposed only on the broker that is the last in the chain of custody of the gross proceeds.[56] That broker is most often the custodian of the securities being sold and has a customer relationship with the seller which allows the broker to collect all necessary information in addition to knowing the proceeds of the sale transaction. We understand and sympathize with the rationale under which Treasury determined not to extend the same special multiple broker rule to multiple digital asset brokers, given the different regulatory landscape of traditional securities brokers and digital asset brokers, to ensure that to the greatest extent possible, information is provided (and at least one broker involved in the transactions provides information) to the IRS and taxpayers about digital assets transactions. However, we also believe that an information reporting regime that results in multiple but incomplete, and potentially conflicting, IRS Forms 1099[57] with respect to the same transaction being provided to taxpayers and the IRS could place undue stress on the administration of the tax system and could require the IRS to devote significant resources to resolving inconsistencies, notices of unreported gross proceeds and/or potential refund claims by taxpayers that may originally overreport in reliance on duplicative forms received. We believe that the goal of tax compliant reporting would be advanced by streamlining the reporting requirements envisaged by the Proposed Regulations as outlined in below.[58]

B. Creation of a "Qualified Digital Asset Reporting Person" Regime

We believe that the effectiveness of information reporting on sales of digital assets will be greatly enhanced if a system can be created that can deliver a single comprehensive information report with respect to each reportable transaction to taxpayers and the IRS. In that case, the IRS will be less burdened by multiple and incomplete or conflicting reports relating to a single transaction, and taxpayers seeking to comply with the tax law will not be at risk of reporting the same gains or losses multiple times based on the receipt of multiple IRS Forms 1099.

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[55] *Id*.

[56] Treas. Reg. § 1.6045-1(c)(3)(iii).

[57] We understand that the IRS intends to release a new IRS Form 1099-DA, which we expect will be used for this reporting. *See* Prop. Treas. Reg. § 1.6045-1(d)(2)(i)(B); *see also* "*U.S. Department of the Treasury, IRS Release Proposed Regulations on Sales and Exchanges of Digital Assets by Brokers*", U.S. DEPARTMENT OF THE TREASURY (Aug. 25, 2023), https://home.treasury.gov/news/press-releases/jy1705 ("These proposed rules require brokers to provide a new Form 1099-DA to help taxpayers determine if they owe taxes….").

[58] Absent a streamlined reporting regime, Treasury could also attempt to provide uniform rules to help determine which of multiple possible brokers should report in different scenarios, as was requested for information reporting in the real estate transaction context in the 1980s. *See supra* note 38.

In order to achieve this goal, we propose creating the concept of a QDARP (qualified digital asset reporting person), which we envision as a service provider to the digital assets market place that will (1) gather and verify information about taxpayers transacting in the digital assets marketplace and have the ability to link wallet addresses with a taxpayer's "real world" identifying information (potentially, through the use of unique identity/privacy tokens discussed in Part VI.D) and (2) receive, aggregate, and reconcile information from various "digital asset middlemen" or other brokers that may touch any given sale or other disposition of digital assets. In order for a person to become a QDARP, it would be required to enter into an agreement with the IRS in which it agrees to aggregate, reconcile, and report all required information, assume responsibility for information reporting and agree to be audited by the IRS. The concept would be similar to the QI and CPEO regimes we briefly outlined above that the IRS has established to facilitate tax compliance in other contexts.[59] Digital asset middlemen and other "brokers" under the Proposed Regulations could enter into agreements with such QDARPs and provide them all the information they have about transactions involving particular wallet addresses. We believe that industry participants would be incentivized to contract with such QDARPs and provide all information in their possession, if liability for failure to comply with information reporting obligations was shifted to the QDARP. We note, however, that we anticipate there would be penalties for persons who qualify as "brokers" and choose to contract with QDARPs, if such persons fail to provide all required information to the QDARP or provide incorrect information, intentionally or in willful disregard of tax law.

While certain established CEXs may decide to retain the reporting function completely or partially in-house, many industry participants interacting with DEXs or treated as facilitating DEX transactions by providing interfaces or other services may strongly prefer to delegate their information reporting responsibilities by contract to a QDARP, because such industry participants might not otherwise be able to comply with the information reporting requirements without potentially substantially changing their operations.

As discussed in greater detail in Part VI below, with respect to a DEX, it might not be clear which entity or what person might contract with a QDARP to assume reporting responsibilities. But even in connection with transactions involving DEXs, we believe that overlapping obligations to report among many industry participants (such as providers of interfaces and wallets) that each have touchpoints with the same transaction will ensure complete reporting, provided these participants gather and transmit the information available to them to a QDARP, thereby fulfilling their own reporting obligations. It may also be possible that open-source plug-ins to DEXs would emerge as a separate service to provide any information that might be missing to complete the reporting.

We recommend that Treasury consult with industry participants about how long it would take to build an infrastructure of vendors that can act as QDARPs in order to align the effective dates for the portions of Final Regulations that would implement such a regime with the shortest realistic timeline for creation of this new infrastructure. We understand that some industry participants believe that building such infrastructure likely will take 12 to 18 months after publication of Final Regulations providing for such a regime.

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[59] See discussion in Part II.B above.

C. Expanded Exclusion for Certain Validators and Certain Software and Hardware Providers

The Proposed Regulations recognize that not every person facilitating a transaction in a purely technical sense should be treated as a "digital asset middleman" and helpfully carve out from "facilitative service" two categories of activities.[60] First, "facilitative service" does not include "validating distributed ledger transactions (whether through proof-of-work, proof-of-stake, or any other similar consensus mechanism) without providing other functions or services if provided by a person *solely* engaged in the business of providing such validating services."[61] Second, "the selling of hardware or the licensing 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" are excluded "if such functions are conducted by a person *solely* engaged in the business of selling such hardware or licensing such software."[62] We fully support these exclusions because the services and products in question, while essential to digital asset transactions, are fundamentally different from the process of effecting sales or other dispositions of digital assets for others. Validation of transactions is an intrinsic feature of blockchain technology, but validators generally have minimal connection to transactions they validate or the parties thereto. Similarly, providers of hardware and software that is not linked to a trading platform have no ongoing connection to the transactions their customers carry out using their devices or software. Moreover, because of the inherently pseudonymous nature of blockchain technology, we understand that validators definitionally cannot determine the identity of the beneficial owners behind the transactions they validate.[63] That is, while a validator may be able to validate that a particular digital asset has been transferred from public blockchain address A to public blockchain address B and cannot be transferred again from public blockchain address A, we understand that validators cannot determine the identity of the individual or individuals who control the private keys for the addresses.[64]

We believe, however, that limiting the foregoing exceptions to persons "solely" engaged in validation or provision of certain hardware or software is unduly narrow. Even if such persons are engaged in other activities that are clearly within the scope of "broker" activities, the inherent nature of their validation services or sales/licenses of certain types of hardware and software does not change. Moreover, to the extent such activities involve different sets of transactions, the person's activities as a broker with respect to one group of transactions would not better position the same person to collect and report information with respect to other transactions for which it only provides validation services or certain hardware or software. We believe that the goals of robust information reporting would be adequately served if such persons were required to report information on transactions for which they provide non-exempt, facilitative services but continue to remain exempt with respect to validation services and sales or licenses of certain hardware and

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[60] Prop. Treas. Reg. § 1.6045-1(a)(21)(iii)(A).

[61] *Id.*

[62] *Id.*

[63] *See e.g.*, Cipher Mining Inc., Post-Effective Amendment No. 2 to Registration Statement (Form S-1) (April 21, 2022) pp. 33, 37 ("Because of the pseudonymous nature of blockchain transactions, we may inadvertently and without our knowledge engage in transactions with persons….").

[64] *See id.*

software. These validators and hardware or software providers are unlikely to possess the relevant reportable information with respect to transactions for which their only involvement is validation or the provision of certain hardware or software. Moreover, well-advised market participants could achieve the same result by separating validation services, exempt sales of hardware and/or exempt licensing of software into a legal entity separate from the legal entity that provides "facilitative services," thereby making this rule a trap for the unwary.

D.   Proposal for a *De Minimis* Broker Activity Threshold and/or Grace Period for Imposition of Penalties.

DeFi industry participants may be individuals, loosely associated groups of individuals, entirely unaffiliated individuals or groups, or business entities that may be treated as associations or partnerships. Well-advised industry participants presumably carefully tailor their activities to ensure that they are fully in compliance with applicable tax and other regulatory requirements, However, we believe some industry participants may unintentionally and unexpectedly find themselves engaged in activities that qualify them as "brokers" under the Proposed Regulations and subject them to information reporting obligations that they may be ill-equipped to fulfill. Potential penalties imposed on a per form basis potentially could impose prohibitive costs in this situation.

A broad definition of "broker" may well be necessary to ensure meaningful information reporting for digital asset transactions. However, we also believe that an appropriate balance could be struck between, on one hand, the goal of complete information reporting and, on the other, imposing a burden on some market participants that they may not be fully able to comply with, or possibly be aware of, for some initial period. In this regard, we believe Treasury could consider providing penalty relief to persons who unknowingly and unintentionally engage in activities that qualify them as "brokers" if such persons remain below a *de minimis* threshold for the number and/or value of transactions facilitated, during a start-up or transitional period.[65] In this regard, the deferred effective date provided in the Proposed Regulations[66] logically would be taken into account in determining the length of such a period; it seems reasonable to assume some dissemination of information among stakeholders about the tax reporting obligations imposed under the regulations will occur prior to the effective date.

Alternatively, or potentially in addition to a temporary *de minimis* threshold, Treasury could consider providing a grace period for any industry participant that has unintentionally violated information reporting requirements after qualifying as a "broker" during which grace period such person can either come into compliance (including potentially by contracting with a QDARP) or adjust its activities so as to avoid qualifying as a broker, without immediately facing

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[65] A *de minimis* safe harbor has been implemented previously in the context of information reporting, so this concept is not unprecedented. *See* JCX-144-15 (Dec. 17, 2015) (discussing the implementation of a safe harbor for *de minimis* errors on information returns, payee statements and withholding).

[66]   Prop. Treas. Reg. § 1.6045-1(q) provides that the rules in the Proposed Regulations will generally apply to sales of digital assets effected on or after January 1, 2025. In addition, Prop. Treas. Reg. § 1.6045-1(d)(2)(i)(C) provides that brokers are generally required to report the adjusted basis and the character of any gain or loss with respect to a sale if the sale is effected on or after January 1, 2026.

penalties for failure to report upon first meeting the definition of a broker.[67] Penalty relief could also be tied to a requirement that such person or the QDARP with which it contracts provide late information reporting.[68] We believe that the government's initial focus on delta 1 trades, simplified standards for determining combined transactions, and penalty relief for good faith compliance efforts in the context of Section 871(m) are helpful analogies for such an approach.[69]

E.   De-linking Broker Reporting and Backup Withholding

Backup withholding will present a practical challenge to implementing an effective regime that encourages compliance by taxpayers in connection with their digital asset transactions.

The Proposed Regulations do not make significant updates to the backup withholding rules. The Preamble concluded that the rules are comprehensive enough to cover digital asset transactions reportable under Section 6045.[70] However, the concept of a digital asset middleman under the Proposed Regulations is broad and, as discussed above in Part V.A, would impose reporting obligations on many participants with ties to a digital asset transaction, even if their ties to the transaction are more attenuated than the relationship between a chain of brokers and

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[67] Treasury appears to have considered a *de minimis* threshold in the context of digital asset payment processors. *See* Part I.B.3 of the Preamble, 88 Fed. Reg. at 59590. While the preamble acknowledges the potential incremental cost and effort associated with reporting numerous smaller merchant transactions, Treasury decided not to include a *de minimis* threshold on the basis that (1) reporting entities have declined to make use of similar thresholds in other regulatory contexts, (2) taxpayers may engage in multiple smaller dispositions, which ultimately result in an significant aggregate gain for a taxable year and (3) the purpose of information reporting is, in part, to assist taxpayers in accurately determining gain or loss attributable to the disposition of their assets. *Id*. We do not believe that the rejection of a permanent *de minimis* rule for digital asset payment processors should preclude the creation of a *de minimis* rule limiting the imposition of penalties during a start-up or transitional period. We believe this differs fundamentally from digital asset payment processors whose core business consists of processing significant volumes of transactions, for example as third party settlement organizations or payment card issuers.

[68] Similar safe harbors have been implemented on the state law level. For example, California amended its state tax code in 2019 to impose penalties on taxpayers who failed to file correct information returns or to otherwise comply with information reporting requirements (such penalty to be determined in accordance with Section 6721 of the Code). *See* California Code 2019, Cal. Rev. & Tax Code § 19183 (effective Jan 1, 2020). Such penalties, however, may be waived if relevant taxpayer enters into a voluntary disclosure agreement with the California Franchise Tax Board. *See* California Code 2019, Cal. Rev. & Tax Code §§ 19191(b)(4), (d) (requiring the California Franchise Tax Board to consider, among other things, the "lack of evidence of willful disregard or neglect of tax laws of [the] state" and "demonstrations of good faith on the part of the [taxpayer]" when deciding whether to enter into a voluntary disclosure agreement with a qualified taxpayer).

[69] *See* IRS Notice 2022-37; IRS Notice 2020-02; IRS Notice 2018-72; IRS Notice 2016-76.

[70] *See* Treas. Reg. § 31.3406(b)(3)-2 for the backup withholding rules for specific types of transactions reportable under Section 6045; Treas. Reg. § 31.3406(b)(3)-2(b)(2) for backup withholding rules for brokers reporting on foreign currency contracts and regulated futures contracts subject to Section 1256; and Treas. Reg. § 31.3406(b)(3)-2(b)(3) and (4) for backup withholding rules related to brokers reporting on securities sales made through a margin account and security short sales. Under the Proposed Regulations, certain controlled foreign corporations ("**CFCs**") and non-U.S. digital asset brokers are not required to apply backup withholding on payments of gross proceeds from the sale of digital assets. In each case, so long as the payor (i.e., the broker) is not conducting activities as a money services business ("**MSB**"), it will not be required to backup withhold with respect to reportable sales unless it has actual knowledge that the customer is a U.S. person. *See* Prop. Treas. Reg. § 31.3406(g)-1(e). If the payor does have actual knowledge that a customer is a U.S. person and the customer does not provide an IRS Form W-9, the payor must report a sale or exchange of a digital asset by that customer to the IRS and backup withhold on the gross proceeds from that transaction. *See id*.

middlemen in a traditional securities transaction. The obligation to backup withhold is imposed on the person required to report. Generally, this person is treated as the payor.[71] Backup withholding can be a significant effort and when a payor does not collect and remit backup withholding where required, it may be liable for any uncollected amount. However, not everyone who may have access to certain information regarding a given digital asset transaction will necessarily have control over the digital assets or cash on which to properly withhold. Also, with respect to services provided in exchange for digital assets, many payors will not know how to apply backup withholding and may need to withhold on amounts paid to customers. Moreover, complex questions arise around whether and how backup withholding should be required when the amount received takes the form of other digital assets rather than fiat currency, including where a payor required to backup withhold would need to liquidate digital assets in order to do so. This may apply to illiquid assets and non-fractional assets like NFTs as well.

Currently, in the DEX space in particular, protocols are not set up to implement backup withholding mechanics, which could require liquidating digital assets, converting them to fiat currency and then remitting amounts to the IRS. Even if certain protocols can be modified to fulfill these requirements, immutable protocols currently exist that will not be able to comply.

The persons that presently may be best positioned to assume primary backup withholding responsibility in respect of DEX transactions are wallet providers or potentially DEXs that are under sufficiently centralized control to qualify as "brokers". On the other hand, a QDARP might not be in a position to exercise sufficient control over digital assets to backup withhold. This raises the larger issue of de-linking backup withholding from the IRS Form 945 and 1099 reporting. We recognize that there would need to be a mechanism for tying the backup withholding remittance to the IRS with the IRS Form 945 and 1099 reporting to the IRS; otherwise, the IRS would not be able to credit the payor as applying backup withholding correctly.

Taking the example of a wallet provider or DEX that may provide the funds for backup withholding, without some reporting mechanism to connect the backup withholding deposits to the reporting by the QDARP, withholding may not be appropriately credited. Thus, we would propose a system similar to the IRS Form 1042-S regime where the wallet provider or DEX would provide the QDARP with IRS Forms 1099 showing backup withholding and the QDARP would credit the withholding done by the wallet provider or DEX, similar to the way withholding on IRS Form 1042-S is reported when the withholding is done by a person other than the person that provides the IRS Form 1042-S to a beneficial owner.

In addition, although the Proposed Regulations include a grace period for certain purposes[72], a transition period might be more optimal. Industry experience under FATCA and

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[71] Treas. Reg. §§ 31.3406(b)(3)-2(a), 31.3406(a)-2(a).

[72] Under the Proposed Regulations, a payor has a grace period to obtain documentation to substantiate non-U.S. status. Specifically, a payor may treat an account as owned by a non-U.S. person until the earlier of either 90 days from the date the payor first credits a new account or the date the payor first credits an existing account after the existing documentation can no longer be relied upon (for an existing account), or the date when the remaining balance in the account is equal to or less than the applicable statutory backup withholding rate of the total amounts credited during the grace period. A payor may also use the grace period only if at the beginning of the grace period it has a non-U.S. address for the account holder in its records, it has a withholding certificate on file, or it holds a withholding certificate that is no longer reliable other than because the validity period has expired. *See* Prop. Treas. Reg. § 1.6045-1(g)(4)(vi).

third-party payment transactions (Section 6050W) has demonstrated that obtaining documentation for preexisting accounts is a difficult and arduous process. The original Section 6045 rules had included provisions for pre-1984 and post-1983 accounts, which called off certain aspects of backup withholding and providing a TIN in favor of a transition period. As discussed further below in Part VI.C, the existing off-ramps which convert digital assets into fiat currency may be the best point to administer and collect backup withholding with respect to all the transactions that may have been completed by a particular digital asset wallet or address, at least in the interim or phase-in period. Off-ramps can use the fiat currency into which a digital asset has been converted to make a payment of backup withholding; and they may already have the necessary infrastructure to comply with backup withholding requirements. This approach may provide for a faster initial implementation of backup withholding, while a more expansive infrastructure is being designed and built by a wider group of participants in digital asset market place. The length of a transition period of the type just described logically would be determined taking into account the deferred effective date provided in the Proposed Regulations.[73]

In order to minimize situations where backup withholding occurs, we recommend that the Final Regulations explicitly permit utilizing the IRS TIN Matching Program for digital asset reporting.

VI. Decentralized Exchanges and Protocols

A. Clarification in an Example That Certain DEXs With a Widely Distributed Governance Structure Are Not Treated as Brokers

Treasury has requested comments on various aspects of applying the Proposed Regulations to DeFi. As discussed in Part II.A above, DeFi comes in many variants, some of which are more "centralized" than others. We believe that Treasury is trying to strike the correct balance by focusing on "digital asset middlemen" that have persons who have the power to modify protocols and charge fees. However, we understand that at least some of the largest currently existing DEXs operate on the basis of immutable self-executing code. In those protocols, changes to the underlying software cannot be made. Moreover, the DAO that may be responsible for governing a particular currently existing DEX may be built on the principle of "governance minimization," which may allow votes on smart contracts involving predetermined fee tiers and other predetermined matters, but not allow votes on the overhaul of a protocol to build in the systems required for information reporting and backup withholding. So, the ability to charge or modify fees is not necessarily coterminous with the ability to modify a given DEX more generally.

Furthermore, as discussed further in this Part VI below, with respect to DEXs, it is unclear how it may be established that there is no ability to set or change the fees associated with the services. We believe that there is an argument that a currently existing DEX using an immutable protocols by definition would be excluded. However, it is not clear whether all currently existing protocols that theoretically could be changed by voting and certain levels of acquiescence of the holders of governance tokens would be deemed to be within the scope of requirements for information reporting or whether a certain level of concentration of ownership of governance tokens that enables the coordination necessary to make changes will be required.

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[73] *See* note 66 *supra* and accompanying text.

More specifically, groups of unrelated, pseudonymous network participants could theoretically be deemed to have the power to change fees even though it is not practically possible for them to work in concert to the extent necessary to alter the protocol. In that regard, we recommend adding at least one example illustrating that diffuse, pseudonymous network participants will not be treated as having the ability to control fees merely because there is a theoretical possibility they could band together to make changes to a protocol. (Our comment in this regard is focused on an example that involves a currently existing DEX using a protocol for which there is not a realistic possibility of alteration. We recognize that if a new DEX that is established in the future which uses an immutable protocol, that fact pattern may involve different considerations.) Such an example in the regulations could be paired with an example of a DEX where Treasury takes the view that sufficient control is present. Such examples should also clarify that while certain DEXs themselves are not brokers, interfaces connecting to such DEXs are brokers that are required to report or contract with a QDARP.

B.   Integration of DEXs into a QDARP Regime

In considering how a DEX might be integrated into our proposal for a QDARP system, we recognize that in some cases, it might not be clear which entity or what person might contract with a QDARP to assume reporting responsibilities. As discussed in Part VI.A., we believe that certain market participants (e.g., a currently existing pseudonymous network of participants with no realistic possibility of acting in concert) should not be treated as a broker that must file information reports with the IRS. Logically, such market participants also should not be required to enter into a contract with a QDARP, due to the same practical constraints that would make it unfeasible for the protocol to collect tax information. Indeed, Treasury may wish to consider whether a DEX's practical inability to contract with a QDARP may serve as indicia of its not meeting the definition of a broker in the first place.

However, even in connection with transactions involving these types of DEXs, we believe that because of overlapping obligations to report among many industry participants (such as providers of interfaces and wallets), there will be several touchpoints to the same transaction that would ensure that reporting is done. It may also be possible that open-source plug-ins to certain DEXs would emerge as a separate service to provide any information that might be missing to complete the reporting.

As discussed above in Part II.A, we understand that the vast majority of parties that transact with DEXs do not wish to and/or do not have the technical wherewithal to transact with the protocol directly, but instead access the protocol through interfaces provided by the sponsor of a protocol and/or third party vendors. These interfaces can be modified and customized to comply with regulatory requirements and are already being modified by some market participants to permit AML/KYC compliance.[74] On a related note, there has been a rise in "permission pooling" or "permissioned liquidity pools" in connection with the operation of some DEXs in order to address

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[74] Several companies have begun offering AML or KYC verification tools for DeFi projects. These include Coinfirm (https://www.coinfirm.com/products/aml-platform/), which   provides AML screening services, and ShuftiPro (https://shuftipro.com/crypto/), which offers KYC verification and AML screening services.

AML/KYC concerns.[75]   Again, the permission requirements are imposed by the creators of a particular liquidity pool and not by the DEX itself.   We therefore believe that permission requirements for liquidity pools as well as user interfaces accessing DEXs may be a particularly logical attachment point for information reporting with respect to transactions taking place on DEXs operating on protocols that are themselves either immutable or have a widely distributed governance structure that does not lend itself readily to taking concerted action by the governance token-holders.

Relying on our core recommendation of building a QDARP regime, we believe that interface providers as well as liquidity pool operators could create plug-ins that would connect their interface or permissioned liquidity pool to a QDARP's systems and transmit information linked to a particular wallet address to such person for aggregation with other information about the transaction and owner of the wallet address. Particularly if combined with a system of an identity or privacy token unique to an individual that we discuss further in Part VI.D, we believe the QDARP regime could facilitate compliance with information reporting requirements for the vast majority of DeFi industry participants while minimizing disruption for existing markets.

C.   **On-Ramps and Off-Ramps**

In order to transact on DEXs, taxpayers must access the DeFi ecosystem through on-ramps to purchase digital assets for fiat currency and must use off-ramps to exchange coins or tokens for fiat currency or use them in "real world" transactions, such as paying for coffee or buying real estate.[76]   On-ramps and off-ramps are generally CEXs and wallet providers that partner with traditional banks or money transmitters like MoonPay or PayPal. In most situations, to exit the digital asset marketplace, a taxpayer would convert a digital asset or cryptocurrency into fiat currency with the help of a money transmitter. While there may be a perception that stablecoin is directly exchangeable into fiat currency, we understand that as a technical matter, such exchange in most situations would involve a money transmitter entity that is responsible for handling fiat currency, whether such transaction occurs in a financial context (cashing out) or spending stablecoin on personal consumption such as movie tickets or cars. On-ramps and off-ramps have access to information about the "real world" identity of the person associated with a particular wallet address and can serve as the link between the world of pseudonymous transactions using DEXs and an identifiable taxpayer. We also understand that off-ramps have the technical ability to see all transactions associated with a particular wallet address from the moment it started to transact with respect to a particular digital asset until the moment the digital asset is disposed in exchange for fiat currency.

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[75] For example, Aave, a DeFi lending/borrowing protocol, which is governed by DAO, introduced Aave Arc in January 2022. Aave Arc allows liquidity pools to add permissioning. In these permissioned liquidity pools, lenders and borrowers must be approved by a central body of "whitelisters". *See* PYMNTS, DeFi Platforms Tighten AML to Court Institutional Investors (Aug. 18, 2022), https://www.pymnts.com/cryptocurrency/2022/defi-platforms-tighten-aml-to-court-institutional-investors/.

[76] We recognize that it is technically possible for two parties to come together and exchange tangible goods or services directly for cryptocurrency or other digital assets, but we also understand that such transactions are extraordinarily rare and require accommodations that would not be expected in routine commercial transactions.

We understand that many in the DeFi industry believe that information reporting obligations should attach only to the on-ramp and off-ramp because those persons effecting transactions can link information to the "real world" and the off-ramp has visibility into the entire transaction history relating to digital assets linked to a particular wallet address. While, in principle, this may be an appealing argument, focusing information reporting requirements only on the on-ramps and off-ramps does not fit well into the annual accounting requirement that underlies our tax system since the off-ramp would report on transactions that may have been carried out over an unlimited number of years.[77] We therefore believe that it would not be appropriate for the proper administration of the tax law to limit information reporting only to the sales or other dispositions that occur at the on-ramp and off-ramp into and out of DeFi. However, the on-ramps and off-ramps may be in a good position to provide information to QDARPs, so they can reconcile and tie out all of the inputs received from all "brokers" facilitating each of the transactions recorded on the blockchain and can complete required information reporting with respect to the current year and potentially reconstruct information reporting for past tax years on a retroactive basis.

As noted in Part V.E, off-ramps may initially be the best place to implement backup withholding with respect to transactions on a DEX, because such off-ramps are the last (and in some instances, the only) person having custody of the taxpayer's cash and such off-ramps already have existing infrastructure to administer backup withholding. Typically, a person utilizes a regulated CEX, such as Binance or Coinbase, to convert digital assets to cash. In theory, methods of converting digital assets to cash without an intermediary are possible (such as direct peer-to-peer exchanges), but such transactions carry significant counterparty risk and the availability of such transactions is limited. As such, using CEXs is the primary avenue for such conversions. CEXs are regulated under federal law as money services businesses[78] and generally under state law as money transmitters,[79] meaning they generally must comply with applicable AML and KYC

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[77] We understand that there is also a perception among some industry participants that transactions within DeFi do not crystallize gains or losses until digital assets are exchanged for fiat currency by an off-ramp. There is also a perception that digital assets are generally not accepted or are cumbersome and difficult to use as a method of payment and therefore taxation may better be deferred until digital assets are exchanged for fiat currency. We do not believe this argument has substantive merit. However, as a matter of requiring information reporting with respect to transactions on DEXs, we believe that the ability of off-ramps to provide a complete history of all transactions engaged in by a particular wallet address provides a useful backstop to the IRS. Having this ability to easily reconstruct and audit transactions on blockchain whether they were or were not reported on an annual basis may provide a degree of comfort to the IRS to detect non-compliance.

[78] See "*Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*", U.S. DEPARTMENT OF THE TREASURY, FINANCIAL CRIMES ENFORCEMENT NETWORK, https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering.

[79] See e.g., "*Department of Banking Issues Consumer and Industry Advisory on Money Transmission*", BANKING COMMISSIONER CONNECTICUT, https://portal.ct.gov/-/media/DOB/Consumer-Credit-Licensing-Info/Department-of-Banking-Issues-Consumer-and-Industry-Advisory-on-Money-Transmission.pdf (Connecticut); "*Virtual Currency and Money Transmission Laws*", WASHINGTON STATE DEPARTMENT OF FINANCIAL INSTITUTIONS, https://dfi.wa.gov/sites/default/files/virtual-currency-money-transmission-laws.pdf (Washington).

requirements.[80] When CEXs transfer cash to persons in exchange for digital assets, generally a bank or depository institution is involved in the transaction as the CEXs will not have direct access to the cash payment rails (e.g., Automated Clearing House or ACH). Accordingly, the cash is transferred from the CEX's account at its bank or depository institution and the CEX updates its internal ledger to reflect the transfer. Similar processes and infrastructure would be involved with respect to payment processors and other businesses that would provide conversion services as money services businesses or money transmitters. As traditional financial intermediaries and institutions that operate within the framework of existing AML and KYC requirements and that in fact have custody of the funds, such persons appear to be in a good position to obtain proper tax documentation and use their existing systems to perform backup withholding.

D.   Identity/Privacy Tokens

One potential advantage of DeFi is to allow more frictionless financial activity. In the current financial services industry, one significant source of friction is compliance with AML and KYC requirements and collection of tax information at multiple levels in the systems and with respect to multiple legs of a single transaction. Participants in the DeFi industry believe that the creation of "identity tokens" associated either with an individual or entity or with specific wallet addresses could minimize friction in DeFi transactions while simultaneously permitting compliance with regulatory requirements. An authorized service provider could mint an identity token (likely in a form of an NFT that is "soulbound" and not transferrable) for a taxpayer after collecting all the necessary taxpayer information to generate a substitute IRS Form W-9 or Form W-8.[81] An identity token that embeds an IRS Form W-8BEN or W-8BEN-E can also be programed to expire automatically and require a new token to be minted at regular intervals for someone to continue transacting.[82] In addition, an identity token can be used to prove exempt recipient status, such as a taxpayer's status as a corporation. An identity token may be linked to each wallet owned by the individual or entity and provided as the identifying information with respect to transactions entered into by such wallets. Alternatively, an identity token could be created for each wallet address linking it to the name, TIN and other relevant information for a particular taxpayer at a CEX or other on-ramp into the digital asset ecosystem. That unique identity token would then be furnished to each person providing brokerage or "facilitative" services and could be used by that person when transmitting the information it possesses about transactions from a particular wallet address to the QDARPs with which it contracts. A QDARP in turn could aggregate all the transaction information associated with a particular identity token and then generate the required information reporting to the IRS and the taxpayer. In that regard, one may envision a single aggregate IRS Form 1099 being generated by a QDARP based on the reconciled information for

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[80] *See* "*Application of FineCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies*", U.S. DEPARTMENT OF THE TREASURY, FINANCIAL CRIMES ENFORCEMENT NETWORK, https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf.

[81] *See e.g.*, Treas. Reg. § 1.1441-1(e)(4)(iv) for the current requirements to ensure compliant electronic submission of substitute IRS Form W-8 and Rev. Proc. 96-26 for the requirements for incorporating a substitute IRS Form W-9 in customary business forms.

[82] An IRS Form W-8BEN or IRS Form W-8BEN-E will remain valid for purposes of both chapters 3 and 4 for a period starting on the date the form is signed and ending on the last day of the third succeeding calendar year, unless a change in circumstances makes any information on the form incorrect. *See* Treas. Reg. §§ 1.1441-1(e)(4)(ii) and 1.1471-3(c)(6)(ii).

all the transactions associated with a particular identity token, regardless of the multiple DEXs and other industry participants that may have effected or facilitated such transactions. Such a form may be akin to an aggregate IRS Form 1099-B generated by a custodian broker under the current broker reporting rules applicable to securities. Hosting the information regarding a person's "real world" identity on a private tax "identity token" potentially accessible and readable only by a QDARP (rather than sharing such information with each person in a chain of transaction steps that may provide "facilitative services") should alleviate concerns from taxpayers about privacy and identity theft.[83]

While we believe that this solution holds significant promise, it is not clear whether the industry currently has the technical ability to introduce such identity tokens and maintain their security. We therefore believe Treasury should consult with industry participants to confirm whether any security, identity theft and unique identification concerns can be met if this solution is mandated.

E. Reporting of Historic Transactions on Blockchain

DEXs that are permissionless and composable may operate outside of the QDARP regime, because those DEX can be accessed directly (although with considerable difficulty) without any interface. Such transactions may not be transmitted to a QDARP and therefore would not be captured annually by information reporting systems. Once vendors acting as QDARPs become established in the market, it may be reasonable to expect that they will seek to build bridges to bring such DEXs into the fold as quickly as possible – building themselves on open-source software and composable protocols. But there may be a time lag, and not 100% of the players in the DeFi ecosystem may be able to be captured at any given time. We do not believe that the possibility of a small fraction of overall transactions escaping annual information reporting will have a material impact on the overall viability of the QDARP regime in combination with tax identity tokens.

In significant part, we believe this conclusion is warranted because all transactions are irreversibly recorded on blockchain and, as discussed above, could be reported in their entirety by off-ramps, once digital assets are converted into fiat currency. It may even be possible at that time to reconcile such transactions with transactions previously reported by QDARPs and potentially require historic reporting of the transactions that were not previously reported by QDARPs based on information from the off-ramp. Under a QDARP agreement, the IRS could be given access to such information, which it could use in connection with audits. Eventually, we believe the number of transactions conducted without tax identity tokens and without being transmitted into a QDARP would become small. We recognize that even with all the safeguards and proper incentives, a part of the digital asset ecosystem will continue to transact pseudonymously, although it would be significantly curtailed and could potentially be addressed by other means targeting specific violations.

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[83] If off-ramps are required to report information about the "real world" identity of every transaction party connected to particular wallet addresses, this will create a database of information potentially linking all wallet addresses associated with a particular transaction party. This may be a valuable source of information for the IRS in auditing taxpayers that act through multiple wallets as well as provide insight into transaction histories for periods before the effective date of Final Regulations.

VII.   Stablecoin Transactions

Treasury has requested comments around the need for and mechanics of information reporting for transactions involving stablecoins. The Proposed Regulations take the view that transactions involving stablecoins should be reported "because [ ] broker[s] may not be able to identify which stablecoins will perfectly and consistently reflect the value of the currencies to which they are linked, if any."[84]

The treatment of stablecoins under the substantive tax law remains unclear and, as noted in the 2022 Report,[85] there are numerous potential alternatives, including treatment as (1) indebtedness of the sponsor, (2) ownership of a pro rata portion of the reserve assets held by the sponsor, (3) ownership of the referenced U.S. dollars or (4) a financial contract taxable as property. Any of these characterizations would trigger different information reporting requirements under existing law and raise various collateral questions. We believe that, once Treasury determines the contours of specific information reporting requirements for stablecoin transactions under the Final Regulations, Treasury should clarify that any additional or alternative information reporting requirements that otherwise would be triggered by any of the foregoing characterizations are suspended, until further guidance has been provided on the substantive characterization of stablecoin transactions.[86]

A.   Stablecoins as "Lubricant" and "Cash Equivalent" in the Digital Ecosystem

We agree with Treasury that there may be many transactions involving U.S. dollar-backed stablecoins that, in and of themselves, do not generate significant amounts of taxable gain or loss. The vast majority of transactions involving stablecoins involve USDT or USDC.[87] We understand that those stablecoins often function as a "lubricant" in the digital asset ecosystem, in particular in the DeFi space.[88] More generally, we understand that to trade digital assets directly across blockchains participants frequently utilize stablecoins. For example, we understand that an exchange of token X for token Y through a smart contract often may involve, among other steps, the exchange of token X for a stablecoin and the immediate exchange of that stablecoin for token

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[84] Part I.K of the Preamble, 88 Fed. Reg. at 59608.

[85] *See* the 2022 Report, Recommendation F, pp. 8 and 33; *see also* the 2020 Report, p. 38 - 39.

[86] The discussion in Part VII is limited to USD stablecoins with respect to taxpayers whose functional currency is USD. Further considerations should be given by the IRS to foreign currency stablecoins like EURC or gold-backed stablecoins to determine whether the nature of assets underlying such stablecoins and the regulatory framework to which they are subject supports any special treatment.

[87] As of October 3, 2023, USDT and USDC accounted for approximately 68% and 19%, respectively, of the total stablecoin supply. *See* "Total Stablecoin Supply", THE BLOCK, https://www.theblock.co/data/stablecoins/usd-pegged/total-stablecoin-supply. In September 2023, USDT accounted for approximately 67% trading on crypto-asset trading platforms. *See* "Share of Trade Volume by Pair Denomination", THE BLOCK, https://www.theblock.co/data/crypto-markets/spot/share-of-trade-volume-by-pair-denomination.

[88] Stablecoins provided around 45% of the liquidity in DEXs in May 2022. *See* Mitsu Adachi et al, *Stablecoins' role in crypto and beyond: functions, risks and policy*, EUROPEAN CENTRAL BANK , https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202207_2~836f682ed7.en.html.

Y.[89] As such, stablecoins often function as cash substitutes and provide an important link in the chain of events that ultimately constitute a single sale or other disposition of a coin or token.

With this functionality in mind, we believe Treasury should consider treating certain stablecoin transactions differently than other digital asset transactions for purposes of information reporting and backup withholding.[90] If Treasury establishes a special exemption for certain stablecoin transactions, it will be essential to define which transactions and which digital assets labeled as stablecoins are within the exemption. We believe it would be possible to identify such stablecoins (which we will refer to below as "**specified stablecoins**") broadly as any fiat collateralized digital assets that are (x) designed to have a stable value over time as compared to typically volatile digital assets and (y) marketed as pegged to the U.S. dollar.[91] To date, there have been several federal and state-level legislative and regulatory attempts to define and regulate stablecoins and it may be possible for the IRS to leverage those efforts to limit specified stablecoins solely to those that qualify as "stablecoins" under applicable legislation or regulation.[92] For

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[89] We understand that on CEXs it may be possible to exchange digital asset X for digital asset Y directly because those exchanges occur on the internal ledgers of the CEX and not directly on the underlying blockchains.

[90] One of the key goals behind the Proposed Regulations is to achieve "parity" between digital assets and traditional financial assets. *See* Letter from Jonathan C. Davidson, Treasury Department Assistant Secretary for Legislative Affairs, to United States Senate, at 2 (February 11, 2022) ("Consideration of regulations in the notice of proposed rulemaking will be based on principles broadly similar to those applicable under current law for broker reporting on securities transactions."). Excluding stablecoins that function as cash equivalents from information reporting would align with this goal.

[91] While we recognize that the Treasury may consider expanding the definition of stablecoins for this purpose to algorithmic coins in order to capture most transactions where stablecoins may be used as a lubricant, we understand that the general consensus in the industry is that algorithmic stablecoins have experienced disproportionate degree of failure and may not operate as intended.

[92] For example, in April 2022, Senator Pat Toomey released draft legislation aimed at regulating the issuance of "payment stablecoins". The draft legislation defined a "payment stablecoin" as:

> A convertible virtual currency that: (1) is designed to maintain a stable value relative to a fiat currency; (2) is convertible directly to fiat currency by the issuer; (3) is designed to be widely used as a medium of exchange; (4) is issued by a centralized entity; (5) does not inherently pay interest to the holder; and (6) is recorded on a public distributed ledge.

Senator Toomey's bill also proposed requiring stablecoin issues to provide monthly disclosure on their stablecoin activities. *See* Stablecoin TRUST Act of 2022, SIL22574, https://www.banking.senate.gov/imo/media/doc/the_stablecoin_trust_act.pdf.

Additionally, in June 2022, Senators Kirsten Gillibrand and Cynthia Lummis introduced the bipartisan Responsible Financial Innovation Act, which was also aimed at regulating "payment stablecoins". The bill would require stablecoin issuers to hold an amount of "high-quality" liquid assets equal to 100% of the face value of the stablecoins. Under the proposed legislation, "high-quality" liquid assets included U.S. currency, Treasury bonds and Federal Reserve deposit balances.

See Lummis-Gillibrand Responsible Financial Innovation Act, SIL22785 § 601, https://www.lummis.senate.gov/wp-content/uploads/Lummis-Gillibrand-Responsible-Financial-Innovation-Act-S.4356.pdf.

On July 27, 2023, the House Financial Services Committee approved an updated version of the "Clarity for Payment Stablecoins" Act (H.R. 4766), which seeks to provide a clear regulatory framework for the issuance of payment stablecoins.

example, the most recent stablecoin legislation approved by the House Financial Services Committee defines "payment stablecoin," in part, as "a digital asset that is or is designed to be used as a means of payment or settlement; and the issuer of which . . . represents [that it] will maintain or creates the reasonable expectation that it will maintain a stable value relative to the value of a fixed amount of monetary value…".[93] The IRS could then apply a different set of rules to specified stablecoins, while treating all other digital assets, including those stablecoins (in conventional parlance) that do not meet the definition of "specified stablecoins", as digital assets subject to the general rules for information reporting and backup withholding. As additional regulator-approved stablecoins become available in the market, Treasury could expand the scope of "specified stablecoins" by notices or other forms of guidance.

While a legislative and regulatory framework for stablecoin continues to evolve, Treasury could also consider developing a test that is satisfied if (x) the stablecoin maintains its peg to a fiat currency (within a specified margin, e.g., +/- 5%) on a specified number of days during some testing period (e.g., 180 days out of the year) and (y) the stablecoin was held out by its sponsor (e.g., a juridical entity like Circle) or its software developers (e.g., the development team for DAI) as having the capability to maintain a peg against a fiat currency.

B. Should Stablecoin Dispositions Themselves be Reported?

As discussed in Part VII.A, we believe it is important to capture exchanges of digital assets for specified stablecoins in order to obtain a full history of a transaction. The question remains, however, whether gross proceeds and basis in the specified stablecoin used as a means of exchange should themselves be subject to reporting. We believe that a sale of a stablecoin for cash in an off-ramp transaction should always be reported and should serve as an opportunity to reconcile and verify the blockchain history of a particular wallet as discussed above. However, we also believe that reporting a "sale" of a specified stablecoin for another digital asset in a case where the specified stablecoin is acquired for a short period of time as a bridge between two digital assets would be of questionable value to the system and would place a significant burden on brokers, taxpayers and the government.

We recognize that although the intent is for specified stablecoins to have the constant value (akin to money market funds), the price of such stablecoins may and does vary, which can result in gains or losses on disposition. That concern may be alleviated by defining specified stablecoins in part by reference to their ability to maintain their peg to fiat currency and fit within an applicable regulatory framework, as suggested above. Given the intent and expectation that specified stablecoins will generally maintain a constant value relative to the related fiat currency and given their role as "lubricant" in the digital asset market place, we believe Treasury should consider

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On June 8, 2022, the New York Department of Financial Services ("**DFS**") issued its Guidance on the Issuance of U.S. Dollar-Backed Stablecoins ("**DFS Guidance**"), which outlined general requirements for USD-backed stablecoin issuers. *See* NEW YORK DEP'T FIN. SERV., Virtual Currency Guidance (June 8, 2022), https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220608_issuance_stablecoins#ftn3. The DFS Guidance requires issuers to provide clear redemption policies, follow specific reserve requirements, and, perhaps most importantly, release monthly reports containing details such as the value and makeup of stablecoin reserves, the number of outstanding stablecoin units, and whether reserves are sufficient to fully back all outstanding units.

[93] *See* Clarity for Payment of Stablecoins Act of 2023, H.R. 4776, 118th Cong., § 2(13) (2023).

developing rules generally similar to the rules governing money market funds and short-term transactions in foreign currency, where the government appears to have struck a practical balance by deciding not to require information reporting.

The Section 6045 regulations have long had an exception for sales of shares in domestic money market mutual funds, which generally try to maintain a constant share price of one United States dollar. The current version of Treasury Regulation section 1.6045-1(c)(3)(vi)(A) states that no IRS Form 1099-B[94] is required "with respect to a sale of shares in a regulated investment company that is permitted to hold itself out to investors as a money market fund under Rule 2a–7 under the Investment Company Act of 1940 (17 CFR 270.2a–7)." Notably, this language does not require that the share price actually remain one dollar – only that the fund comply with the relevant regulations under the Investment Company Act. Indeed, prior to T.D. 9774, 81 Fed. Reg. 44508 (July 8, 2016), this exception applied to a fund "that computes its current price per share … so as to stabilize the price per share at a constant amount that approximates its issue price or the price at which it was originally sold to the public."[95] The requirement to attempt to keep the share price stable was eliminated in recognition of so-called "floating-NAV" money market funds. The preamble to the proposed regulations that became T.D. 9774 noted: "Comments received by the SEC in response to the SEC MMF Reform Proposal expressed concern that the existing exception would not apply to floating-NAV MMFs and suggested that requiring transaction-by-transaction information reporting would impose significant new costs on floating-NAV MMFs and intermediaries. Treasury believes that imposing broker reporting requirements on floating-NAV MMFs would result in administrative burdens that are not justified in light of the expected relative stability of floating-NAV MMF share prices."[96]

The Section 6045 regulations also exempt most foreign currency sales from reporting.[97] Under the current version of Treasury Regulation section 1.6045-1(c)(3)(viii), no IRS Form 1099-B is required for sales of foreign currency, unless such sale occurs under a forward or futures contract that requires the delivery of foreign currency.[98]

While the Preamble notes the risk that stablecoins may not have a stable value,[99] it does not explicitly consider the countervailing burden of reporting every sale, redemption or transfer of stablecoins, or the burden on the IRS to receive, process, and store that information. It would be appropriate for Treasury to consider an exception for specified stablecoins in light of the enormous number of transactions likely to require information reporting under the Proposed Regulations;

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[94] Investors in money market funds, unlike holders of stablecoins, usually generate yield that is treated as interest and is reportable on the IRS Form 1099-INT. The fact that holders of stablecoins do not earn a yield solely from their holding a stablecoin supports the inference that stablecoins primarily function as a transactional lubricant in the system rather than a means of investment.

[95] Treas. Reg. § 1.6045-1(c)(3)(vi)(A) (as in effect prior to T.D. 9774).

[96] IN 1545–BM04, 79 FR 43694, 43696 (July 28, 2014).

[97] Treas. Reg. § 1.6045-1(c)(3)(viii).

[98] *Id*. The Section 988 regulations separately carve out spot contracts (i.e., contracts to buy or sell a non-functional currency that settle within two days) from the definition of forward contracts. Treas. Reg. § 1.988-2(d)(1)(ii). The receipt of non-functional currency under a spot contract is not a realization event for purposes of Section 988. *Id*.

[99] Part I.K of the Preamble, 88 Fed. Reg. at 59608.

this would be consistent with the approach to U.S. regulated domestic money market funds where Treasury took notice of the administrative burden and weighed the value of transactional reporting for redemptions of money market shares against that burden.

If Treasury believes that some reporting on disposition of specified stablecoins for other digital assets ought to be required, Treasury should consider an exception for dispositions of specified stablecoins that have been held for less than a specific period of time (e.g., 48 hours consistent with the settlement period for non-reportable foreign currency transactions). Limiting the exclusion to a relatively short period will minimize the potential for gains and losses from fluctuations in value and, in combination with a requirement that only certain regulatorily approved stablecoins could benefit from this rule, should significantly reduce the risk that significant amounts of gain escape reporting.

For clarity, where a taxpayer disposes of a digital asset in exchange for a specified stablecoin, which in turn is promptly used as consideration to acquire another digital asset, our proposed reporting exception would apply only to the latter of these two transactions; the initial disposition in exchange for the specified stablecoin would continue to be reportable. Moreover, the eventual disposition of the new digital asset acquired in exchange for the specified stablecoin in such transactions also would continue to be reportable.

VIII. Scope of "Disposition"

The use of the undefined term "disposition" raises a series of questions about the intended scope of transactions that are required to be reported under the Proposed Regulations. Moreover, while the Preamble specifically notes that the Proposed Regulations do not specify whether loans of digital assets are required to be reported and is similarly silent on transactions involving the transfer of digital assets to and from a liquidity pool by a liquidity pool provider, or the wrapping and unwrapping of a digital asset, the term "disposition" may be broad enough to capture some of the foregoing transactions, in particular with respect to loans, because the Preamble does not define loans or discuss what transactions are intended to fall within the scope of loans that are not being addressed by the Proposed Regulations.[100]

While we recognize the ongoing tension between the as-yet incomplete substantive tax analysis of some of these transactions, in view of the need to craft an effective information reporting regime we believe certain common transactions should be addressed explicitly in the Final Regulations. Below we outline various approaches Treasury could take. On balance, we believe there may be benefits to requiring broader reporting of transactions such as digital asset lending because it will provide Treasury with greater insight into the workings of the digital assets marketplace, which in turn may inform Treasury's ultimate substantive analysis of the transactions in question. A broader requirement would also relieve "brokers" of having to determine what transactions constitute "dispositions" for purposes of the information reporting rules, such as potentially digital asset lending transactions, and then would leave the principals to a given transaction to take a position as to whether or not a reported transaction is in fact a taxable sale or exchange.

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[100] Part I.C of the Preamble, 88 Fed. Reg. at 59592.

A.   Digital Asset Lending

We understand that loans of digital assets are among the most common transactions in the digital asset market.[101] As we discussed in the 2020 Report and the 2022 Report, the substantive tax treatment of such loans remains unresolved.[102] However, the initial exchange of a digital asset for an obligation to return the same or identical digital asset and the provision of cash, stablecoin, or other digital asset collateral as well as the close-out of the loan may well constitute "dispositions" and, in the absence of a statutory provision like Section 1058[103], may be taxable transactions.[104] Given the volume of loans of digital assets, we believe that Treasury should address whether or not the various transfers involved in a transaction documented as a digital asset loan will be subject to reporting under Section 6045 pending resolution of the substantive tax characterization of such transactions.   Treasury could take the view that while the treatment of loans of digital assets as a matter of substantive tax law remains under study, no information reporting with respect to any legs of such loans will be required. On the other hand, Treasury could require reporting but consider whether different information should be required for transactions constituting part of such loans as well as a mechanism for flagging in the IRS's computer systems loans as different from other "dispositions" that clearly constitute sales or exchanges for federal income tax purposes. Treasury could also consider exempting loans of digital assets from information reporting by analogy to the rules applicable to short-term obligations under Treas. Reg. 1.6045-1(c)(3)(xiii) without taking a substantive position.

B.   Staking

As discussed in detail in our 2022 Report, staking (by which we mean earning staking rewards for validating transactions on an applicable blockchain pursuant to a proof-of-stake

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[101] For example, MakerDao, which is the largest current DeFi protocol, enables lending and borrowing of digital assets. Of the 12 largest by "total value locked" protocols, most in some way involve lending digital assets.

[102] See 2020 Report, Part VI.B. p. 36; 2022 Report, Recommendation E, pp. 8 and 24.

[103] Recent administrative and legislative proposals have addressed the potential expansion of Section 1058 to digital assets. *See* "*General Explanations of the Administration's Fiscal Year 2024 Revenue Proposal*", U.S. DEPARTMENT OF THE TREASURY, https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf; Responsible Financial Innovation Act, S. 4356, 117th Cong. (2022), https://www.congress.gov/117/bills/s4356/BILLS-117s4356is.pdf.

The Senate Finance Committee also recently asked questions concerning such an expansion. *See* Letter to Members of the Digital Asset Community and Other Interested Parties, U.S. SENATE COMMITTEE ON FINANCE (July 11, 2023), https://www.finance.senate.gov/imo/media/doc/20230710letterrerequestforcommentsigned.pdf.

[104] On the one hand, a bilateral loan of digital assets between identifiable counterparties negotiated using traditional off-blockchain legal documents that include requirements that would be sufficient to satisfy Section 1058 generally may not be a Section 1001 exchange and therefore maybe should not be a reportable disposition. On the other hand, extensive digital asset lending currently takes place through DeFi pools, which essentially allow a transactor to contribute digital assets to the pool in exchange for a token representing an interest in the pool (i.e., the right to a pro rata share of the lending fees generated by the pool along with a pro rata share of the pool's contributed digital assets). Exchanging a digital asset for an interest in such a pool may well be a Section 1001 exchange, since the token in the pool is a different asset than the underlying digital assets (including because the token may entitle holders to a pro rata share of all lending fees earned by the pool rather than the fees generated by the particular digital asset that was contributed, and impose on holders a pro rata share of any underlying digital assets lost by the pool through bad loans).

consensus mechanism) is an intrinsic feature of blockchain technology employing a proof-of-stake validation mechanism, which is now used in a significant portion of the digital asset ecosystem.[105] There is some uncertainty whether locking up a portion of a person's tokens in order to participate in proof-of-stake validation and/or the governance of certain protocols for which stakers may receive staking rewards in the same or potentially different coins or tokens would involve a disposition.

Given how commonly staking occurs in the market, we believe Treasury should address whether information reporting under Section 6045 applies to the staking of tokens/coins and/or the receipt of staking rewards under the Final Regulations. If a decision is made to exclude staking from the scope of the Final Regulations, Treasury can continue to study how information reporting should apply to transfers of tokens as part of a staking transaction and whether information reporting for staking rewards under Section 6041 would be appropriate. [106]

C. Wrapping of Coins or Tokens

Coins or tokens are typically wrapped because the wrapped coin or token possesses a certain functionality that the unwrapped coin or token does not possess. For example, bitcoin cannot be used on the Ethereum blockchain directly and needs to be wrapped in a compatible token to be usable on Ethereum. This raises the question of whether the wrapped coin or token differs materially in kind or in extent from the unwrapped coin or token and therefore the act of wrapping or unwrapping could constitute a reportable disposition under the Final Regulations. As discussed in the 2022 Report,[107] the substantive tax treatment of wrapping and unwrapping remains unresolved. In that report we noted that a taxpayer should recognize gain or loss in connection with such a wrapping, unwrapping or exchange transaction only if both (i) the transaction results in a transfer of ownership of the asset treated as held by the taxpayer to another person as determined for federal income tax purposes and (ii) the transfer of ownership occurs pursuant to an exchange of property for other property differing materially in kind or in extent. While Treasury continues to study whether wrapping or unwrapping a coin or token should give rise to a taxable exchange, we believe that where the sole purpose of wrapping tokens is to make them usable in a transaction and where such transaction involves a disposition of a digital asset that is itself reportable, treating the wrapping and unwrapping as separate dispositions subject to reporting may generate unnecessary reporting that burdens the IRS (and confuses taxpayers). As in the case of other potential "dispositions", once guidance on the substantive treatment has been issued, the applicable information reporting obligations can be modified.

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[105] 2022 Report, Part III.H, pp. 41-53.

[106] The IRS issued a revenue ruling earlier this year, which clarified that a taxpayer must include the value of staking rewards in their gross income in the taxable year in which such taxpayer gains "dominion and control" over such staking reward. See Rev. Rul. 2023-14, 2023-33 I.R.B. 484.

[107] 2022 Report, Recommendation G, pp. 8-9 and Part III.G, pp. 37-41.