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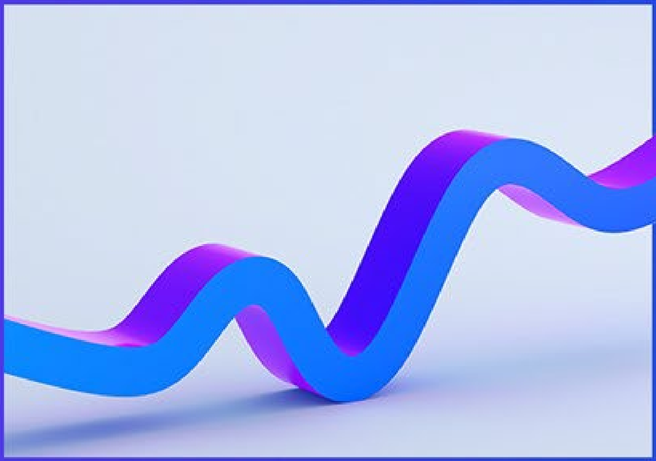

Impact of Proposed U.S. Broker Digital Asset Tax Reporting Regulations on DeFi and Wallet Providers

By Lani Chou, Cyrus Daftary, Philip Garlett, Nelson Suit, and Joshua Tompkins

> This article highlights potential impacts of the proposed U.S. broker digital asset tax reporting regulations on decentralized finance ("DeFi") platforms and wallet providers. In order to determine how (and whether) the rules apply, a platform or wallet provider must apply a detailed assessment against its own particular facts. As such, this discussion is general in nature. Like any proposed regulation, this guidance is subject to change as the U.S. Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") work to finalize the regulations. Notwithstanding the potential for changes, taxpayers should begin identifying compliance needs against these proposed rules now, given the relatively short amount of time before these regulations are scheduled to become effective.

What are the broker crypto reporting regulations?

Treasury and the IRS released proposed regulations on August 25, 2023, that would, when finalized, require certain persons treated as "brokers" effecting "sales" of digital assets (with the term sale defined expansively to include exchanges or digital assets for other digital assets) to report those sales to both the IRS and U.S. customers (that are not exempt from reporting). This would include certain customers that provide no tax

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documentation if they are treated under tax presumption rules as U.S. persons. The proposed regulations are issued principally under the authority of amendments made to existing broker reporting provisions enacted as part of the Infrastructure Investment and Jobs Act of 2021 (the “Infrastructure Act”). The intended purpose is to alert the IRS of a taxpayer’s digital asset sales and also to provide taxpayers with information necessary to complete their tax returns.

The proposed regulations leverage off existing broker reporting regulations that apply to sales of stocks and securities but expands the scope of reporting brokers and the type of transactions that are subject to reporting. Spanning almost 300 pages, the proposed regulations include a detailed preamble that sheds light on the issues that the IRS and Treasury are considering, as well as the reasoning behind some of the policy choices made when drafting the proposed regulations.

Under the proposed regulations, reporting on gross proceeds relating to sales of digital assets would be effective for sales occurring on or after January 1, 2025. For certain sales of digital assets that are classified as “covered securities,” reporting of cost basis for the sale of such digital assets would be required for sales occurring on or after January 1, 2026.

How will this impact an DeFi platforms?

For DeFi platforms and wallet providers subject to the proposed regulations, the information required to be reported would be expansive. In-scope entities would generally be expected to document customers for tax purposes, report on sales of digital assets by U.S. or presumed U.S. customers to both the IRS and the customer, and conduct backup withholding on proceeds paid to customers that have not provided (or provided invalid) documentation and are presumed to be U.S. persons not exempt from reporting.

If a DeFi platform or wallet provider is required to report, the business will need to review its processes or consider new processes for tax onboarding (obtaining and validating customer tax documentation), recording transactional information (e.g., date and time of sale, type of asset sold, wallet address of the seller), and reporting to both the IRS and the customer. In-scope entities will also need to design and implement a process to backup withhold on proceeds of sales.

Which DeFi platforms and wallet providers would be required to report?

The proposed regulations introduce the concept of a Digital Asset Middleman. A Digital Asset Middleman is any person who provides a facilitative service, if the nature of the service arrangement 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 from the sale. Broken down, this definition creates the following requirements, each of which must be met for a DeFi platform or wallet provider to be classified as a Digital Asset Middleman: (i) the DeFi platform or wallet provider is a “person”; (ii) the DeFi platform or wallet provider performs facilitative services; (iii) the DeFi platform or wallet provider knows or is in a position to know the identify the of the party making the sale; and (iv) the DeFi platform or wallet provider knows or is in a position to know the nature of the transaction. If a DeFi platform or wallet provider is acting as a Digital Asset Middleman with respect to a sale of digital assets, it would generally be required to report the sale.

In respect of the first requirement, the term “person” is broadly defined for tax purposes to include individuals, corporations, business entities that are treated as associations or partnerships (among other entities and arrangements). Many DeFi platforms are not formally organized or incorporated under the laws of the United States or another jurisdiction. However, a tax entity may exist under common law principles even in the absence of a formal legal entity. The proposed regulations suggest that certain DeFi platforms might be

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appropriately classified as partnerships even where an actual legal entity may not exist.[1] The determination that a DeFi platform is a tax partnership would carry a number of ramifications outside the context of broker reporting[2] and our understanding is that many DeFi platforms currently take the position that they are not tax persons. Nevertheless, given the new stakes, DeFi platforms would be well-advised to reconsider whether the activities of the platform and its owners could rise to the level of a partnership.

The second requirement is that the DeFi platform or wallet provider provide "facilitative services." The proposed regulations would broadly define this term to include a service that directly or indirectly effectuates a sale of digital assets, such as providing a party in the sale with 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 providing escrow or escrow-like services to ensure both parties to an exchange act in accordance with their obligations. This language would seem sufficiently broad to encompass most activities carried out on decentralized exchanges and decentralized lending platforms. Significantly, the regulations provide that a facilitative service also does not include 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 if such functions are conducted by a person solely engaged in the business of selling such hardware or licensing such software. Thus, wallet providers that do not provide customers with direct access to trading platforms will not be subject to the reporting requirements of the proposed regulations.[3]

For purposes of the third requirement, the proposed regulations provide that a person ordinarily would know or be in a position to know the 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 under which its services are provided to request the party making the sale provide that party's name, address, and taxpayer identification number upon request." That is, if the DeFi platform or wallet provider has the ability amend its contracts or user interface to request such information, then it would be treated as having sufficient control even if it currently does not request such information. In this regard, the preamble notes that a prior history of modifying a protocol "strongly suggests that the operator has sufficient control or influence" to meet this standard.

Similarly, for purposes of the fourth requirement, a person would know or be in a position to know the nature of the transaction as potentially giving rise to gross proceeds (*i.e.*, that it is a sale or exchange) if that person, again, retains sufficient control or influence to determine whether and to what extent transfers of digital assets in a transaction gives rise to gross proceeds, including by reference to fees the person receives from the sale.

In determining the applicability of the reporting requirements, the proposed rules place significant emphasis on the fee structure of the DeFi platform.[4] Whether fees are charged is, to some degree, a question of which parties could be viewed as engaged in a partnership with one another. For example, in certain DeFi platforms, user fees are not retained by the owners of the platform's governance tokens and are instead paid to liquidity providers. In these situations, the fee element would be lacking if the liquidity providers were not treated as partners in a partnership with the governance token holders. In the context of wallet providers, the fee aspect is also important because the receipt of fees will usually occur in connection with the provision of direct trading services.

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[1] Relevant factors for concluding that a partnership exists include: (i) whether the owners of the venture share in net profits; (ii) the intent to form a partnership; (iii) contributions to the venture; (iv) maintenance of books and records; and (v) whether the parties have mutual control and mutual responsibility for the enterprise.
[2] For example, if ownership interests in a DeFi platform are publicly traded, the partnership entity could be taxed as a corporation (i.e., subject to an entity-level tax).
[3] An example in the regulations suggests that wallets that provide customers with the ability to connect to DeFi platforms are not subject to the proposed regulations in the absence of more direct trading services. See Prop. Reg. section 1.6045-1(b)(23).
[4] For example, the ability to change the fee charged by the marketplace on a sale is set forth as an example where a person has sufficient control or influence over the facilitative service in order to be treated as Digital Asset Middleman. The existence of (and control over) a fee structure is also relevant to determining whether a DeFi platform is a person. Lastly, the statutory text enacted by the Infrastructure Act requires that a party receive "consideration" for its facilitative services in order for reporting to be required.

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The other point of emphasis is the degree of decentralization. The proposed regulations could be read to suggest that truly decentralized platforms might not be considered “persons” subject to reporting. In addition, fully decentralized entities may not be in a position to know the identity of the party making the sale or the nature of the transaction if there is no party or group of parties able to control the platform. Thus, whether the proposed regulations will be applicable will involve reviewing somewhat granular workings of the smart contracts and what amendments may be made. For platforms that are not sufficiently decentralized to escape being subject to the regulations, there will also likely be questions as to the appropriate reporting person if control or influence exists within a group of otherwise unaffiliated persons.

What information would in-scope DeFi platforms and wallet providers need to report?

As relevant to DeFi and wallet providers, the proposed regulations would expand the definition of a reportable sale to include the exchange of one digital asset for another digital asset (historically, only transactions conducted for cash were required to be reported) as well as transfers of digital assets in exchange for services or stored value cards. In addition, the information to be reported under the proposed regulations extends beyond the data sets that brokers may have for traditional securities. Reporting would only be required in situations where the broker “effects” the transaction.

This chart summarizes the types and items of information that need to be captured by broker systems for gross proceeds reporting for sales occurring on or after January 1, 2025.

Customer Information	Transaction Information	Transfer Information
Customer Name	Digital Asset (DA) Name	Transfer Date and Time
Customer Address	Digital Asset Quantity (units)	Transfer Transaction ID
Customer TIN	Sale Date and Time	Transfer from Wallet Address (es)
	Gross Proceeds	Transfer Quantity (units)
	Transaction ID	
	Wallet Address (es)	
	Sale For Info (whether exchange is for cash, stored value cards, services, property)	

With respect to the transaction itself, the information to be reported includes the actual date and time of the sale, transaction ID (*e.g.,* the transaction hash for the transaction) and wallet address(es) where the digital assets sold are held. These are data elements particular to digital asset sales transactions that we do not see in the traditional financial services area. In addition, if the digital asset was transferred into the account/wallet, then information relating to that transfer is also required to be reported under the proposed regulations.

As previously noted, where a digital asset is acquired on or after January 1, 2023, and held in a hosted wallet until its sale, the digital asset would be treated as a “covered security.” In such case, for sales beginning on or after January 1, 2026, the proposed regulations would also require reporting of the cost basis with respect to the digital asset sold, whether the gain/loss is long-term or short-term and the acquisition date(s). These rules are not currently applicable to wallet software providers giving users access to unhosted wallets or to DeFi platforms because those entities have no way of knowing a user’s cost basis in the digital assets being sold or

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exchanged. This may change in the future if a comprehensive system of transfer reporting is implemented in future regulations.

What may be some operational issues that can arise with respect to this reporting process?

Reporting to Both Parties to an Exchange: In contrast to the traditional financial system where transactions are conducted for cash, in the context of DeFi most transactions involve the exchange of a digital asset for another digital asset. Thus, each transaction gives rise to two reportable transactions (one for each user). Some DeFi platforms require an interim set of exchanging a digital asset for a stablecoin and then the stablecoin for the new digital asset. This could result in an additional layer of reporting.

Allocation of Transaction Costs: Under the proposed regulations, in a digital asset for digital asset exchange the costs associated with the transaction, including broker fees and gas fees, are allocated 50% to the sold asset (to reduce amount realized) and 50% to the asset acquired (as additional basis). This is different than how broker systems work for sales of securities where costs are all allocated to the sold asset, since for traditional securities sales, reporting is only required for sales for cash.

Existing Tax Uncertainties: There is significant uncertainty as to the proper tax treatment of many common digital asset transactions. For example, it is not currently clear whether lending digital assets, wrapping digital assets, staking using a liquid staking protocol, or entering/exiting a liquidity pool are taxable exchanges. The proposed regulations did not address these questions. Nevertheless, DeFi platforms and wallet providers will be forced to take a position on these questions when implementing broker reporting.

Backup Withholding: One of the enforcement mechanisms for domestic reporting is that if an account holder is presumed to be a U.S. non-exempt recipient and has not provided valid documentation, the broker is required to backup withhold on proceeds at the rate of 24% and deposit this tax with the IRS. There is currently no exclusion for brokers interacting with unhosted wallets where the broker does not have access or control over the digital assets being sold or received. It is not entirely clear how a backup withholding system could be implemented in this context.

Duplicative Reporting: In many cases, multiple Digital Asset Middlemen would be required to report on the same transaction. For example, non-exempt wallet software providers could be required to report a DeFi transaction alongside a reporting DeFi platform. Treasury and the IRS indicated that this was a conscious choice to limit the possibility of under-reporting, but the duplicative reporting could result in user confusion.

Collecting and Storing User Information: Many DeFi platforms and wallet providers have historically not obtained customer information – embracing the pseudonymous nature of blockchain technology and the greater levels of privacy and security it provides. This means that DeFi platforms and wallet providers do not currently have processes and procedures in place for collecting and storing user information and will need to develop that critical infrastructure.

Governance Issues: In many cases DeFi platforms are controlled by decentralized autonomous organizations ("DAOs") and in some situations the governance framework of the DAO may complicate hiring employees and service providers and developing the necessary processes and procedures to implement broker reporting. In situations where a DAO is unable to implement reporting, a critical question would be whether other entities (e.g., the protocol developer) could be required to implement a reporting process on its behalf.

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To whom does a DeFi platform or wallet provider need to report? Are there exclusions from reporting?

Generally, the proposed broker reporting regulations require reporting to customers that are U.S. persons. Certain U.S. persons that the IRS deem to be low risk for avoiding taxes are exempted and are classified as "exempt recipients." This includes corporations (but not S corps if the digital asset is treated as a covered security), U.S. tax-exempt organizations and IRAs, banks, governmental entities, and certain other entity holders. This includes individuals or those presumed to be individuals are not exempt recipients nor are partnerships.

To the extent that a DeFi platform or wallet provider can document a customer as a non-U.S. person, reporting to that customer is generally not required. For U.S. digital asset businesses, a Form W-9 should generally be requested from a U.S. customer and a Form W-8 from a non-U.S. customer. There are situations such as for a digital asset broker/marketplace that is a controlled foreign corporation or that is a non-U.S. payor or middleman (in each case not registered as a money services business with Treasury) to utilize certain documentary evidence (such as passports) to show non-U.S. status.

There is also an exclusion from reporting for non-U.S. DeFi platforms that are not a controlled foreign corporation and not registered as a money services business, with respect to a customer if no U.S. indicia is found in that customers' account or, if it is found, the indicia are "cured" by the customer providing additional documentation to support the customer's non-U.S. status.

If the customer does not provide any documentation or the documentation provided is invalid or has expired, there are presumption rules that would allow a broker to presume the status of the customer for reporting purposes. These rules will often presume the customer to be a U.S. non-exempt recipient subject to Form 1099 reporting (in which case, as discussed above, backup withholding may also apply).

Are there other significant aspects of these regulations that DeFi platforms should be concerned with?

DeFi platforms are generally closely held during their infancy and then decentralized over time. The proposed regulations appear to suggest that in some situations sufficiently decentralized platforms may not be considered Digital Asset Middlemen subject to reporting. This may factor into the decentralization timeline for entities currently going through that process and could disadvantage new market entrants vis-à-vis their more established competitors.

What are steps that can be taken now with respect to the proposed regulations?

There are numerous actions that DeFi platforms and wallet providers can take now even though the regulations have not been finalized:

- Begin assessment of the applicability of the proposed regulations.
  - Determine whether the DeFi platform constitutes a "person" for purposes of the proposed regulations and, relatedly, whether there is a party or parties with control over the platform.
- If applicable, begin assessment of the impact of proposed regulations against current business model.
  - The review may consist not only of the challenges to compliance but also provide a look at whether there is flexibility for parts of the business model, relationships, arrangements, and contracts to be amended to be treated differently under the proposed regulations.
- Talk to peers to understand industry segment approach to the regulations and the issues they are seeing, possibly to coordinate feedback on the regulations.

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- There are 50 questions that the Treasury and IRS have asked feedback on; these questions provide an indication of the types of issues the government is currently considering and areas where the regulations are more likely to be changed when finalized.

- Draft comments to the proposed regulations on issues that matter to the business (the deadline is October 30, 2023, but likely the IRS would consider additional industry feedback prior to finalization of the regulations).
  - Consider whether there are potential solutions that could be offered to the IRS and Treasury to ensure accurate reporting without placing an undue burden on the industry.
  - After initial comments are provided, continue to educate the IRS and Treasury about the complicated processes and issues specific to DeFi.
- Educate key stakeholders about the proposed regulations, not only because they may need to implement compliance systems, but also because they may better understand the practical and technological operations of the platform that could influence the applicability of particular reporting rules and the design of compliance processes.

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