Tax Clinic

Early signs from Treasury on the scope of digital asset cost basis reporting

Pete Ritter, J.D., LL.M., San Francisco; Joshua Tompkins, CPA, Minneapolis; and Hubert Raglan, LL.B., LL.M., Detroit

Editor: Mary Van Leuven, J.D., LL.M.

Procedure & Administration

Information reporting is an important part of the U.S. tax system, given that the system relies in large part on selfreporting. Information reporting greatly increases tax compliance by making it easier for taxpayers to comply with their tax reporting obligations and by ensuring that they are aware a reportable transaction has occurred.

There is a perception in some corners that cryptoasset transactions are not being reported accurately by all taxpayers. Although there is likely some intentional underreporting, noncompliance is often a result of the novelty of the technology and the fact that many cryptoasset market participants are not aware of their tax obligations. To address this, Congress recently expanded the cost basis reporting rules of Sec. 6045 as part of the Infrastructure Investment and Jobs Act, P.L. 117-58 (the Infrastructure Act), to require "brokers" to provide cost basis reporting for "digital assets." For this purpose, a broker is defined as including "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person" (Sec. 6045(c)(1)(D)). Digital assets include most instruments commonly referred to as "cryptocurrencies" and are defined as "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary" (Sec. 6045(g)(3)(D)).

Although Congress can hardly be faulted for seeking to promote tax compliance in the cryptoasset arena, the approach taken attempts to apply the existing cost basis reporting framework used for stocks and securities to digital assets, despite the fact that there are significant differences between the digital asset ecosystem and the stock and securities markets. This raises a number of significant issues (a few of which are considered below) that Treasury will have to grapple with when it provides cost basis reporting guidance.

Miners and stakers

The Infrastructure Act's cost basis reporting provisions prompted a great deal of consternation from the cryptoasset industry because reporting rules would (at least in the view of some tax practitioners) create a requirement that certain participants (including so-called miners and stakers) provide cost basis reporting information to other market participants, notwithstanding the fact that these participants would not have the information to do so.

To illustrate this issue, a bit of background is necessary. Generally, cryptoassets use a peer-to-peer model that is decentralized, in the sense that no single company or person operates the network.

Instead, blockchain technology, which is sometimes referred to as distributed electronic ledger technology, enables this peer-to-peer model to function. Whenever a given cryptoasset transaction occurs, it is first broadcast to its network to be verified or validated.

Validation occurs using cryptography (that is, encryption and decryption) through a consensus process called mining or staking. Once confirmed, each transaction is then recorded with other transactions in a "block" of computer code and is then added and linked to previous blocks to form a chain — therefore, the term blockchain. The updated ledger is then distributed across the network, such that all computers on the network are constantly verifying that the blockchain is correct. Thus, the blockchain itself is, theoretically at least, both immutable and accurate.

Mining (through proof of work) is the original validation process and generally is associated with bitcoin. Essentially, the first "miner" to solve a crypto puzzle or algorithm to validate a given transaction and broadcast to the network is rewarded with newly minted/ created bitcoin as well as transaction fees.

Staking (through proof of stake) is generally associated with the Ethereum consensus layer (formerly known as Ethereum 2.0). At a very high level, "validators" contribute and lock up (or "stake") their own crypto in exchange for a chance of getting the opportunity to validate a new transaction, update the blockchain, and earn a reward. If those validators are selected and successfully verify a given transaction, then the network updates the blockchain, and staking rewards (new tokens) are awarded.

Miners and stakers are the backbone of the blockchain, but they are not omniscient. They generally do not know the identities of the parties transacting on the blockchain and do not have detailed information regarding the gross proceeds or cost basis of the digital assets transferred. In short, they do not have the information required to provide cost basis information to parties transacting on the blockchain. Notwithstanding this fact, many were concerned that miners and stakers could be considered brokers because their validation activities could be considered "effectuating transfers of digital assets."

Congress did not help matters by putting forth two conflicting amendments (one would exempt only miners from broker status, and one would exempt both miners and stakers) before ultimately failing to pass either amendment. With that said, the primary drafters of the legislation have publicly stated that it was not intended to result in reporting responsibilities for miners and stakers and wrote a letter to Treasury Secretary Janet Yellen to that effect (Sens. Rob Portman, Mark Warner, Mike Crapo, Kyrsten Sinema, Pat Toomey, and Cynthia Lummis, Letter to Yellen (Dec. 14, 2021)). A subsequent legislative proposal — the Keep Innovation in America Act, H.R. 6006 — has echoed this interpretation.

Treasury offered encouraging signs in a letter released in February, which states that in "the Treasury Department's view … ancillary parties who cannot get access to information that is useful to the IRS are not intended to be captured by the reporting requirements for brokers. For example, persons who are just validating transactions through a consensus mechanism are not likely to know whether a transaction is part of a sale" (Jonathan Davidson, Treasury Assistant Secretary for Legislative Affairs, Letter to Sens. Lummis, Warner, Portman, Sinema, Toomey, and Crapo (Feb. 11,

2022)). Thus, it would appear that, consistent with congressional intent, miners and stakers will not be subject to cost basis reporting in forthcoming cost basis reporting regulations.

Wallet providers

Cryptoassets are held in "wallets." Some wondered if the creator of wallet software could be considered a broker because software is used to effectuate cryptoasset transfers. Again, the primary drafters of the legislation clearly indicated that wallet software providers were not intended to be covered. Treasury appears to agree with this interpretation and stated in its recent letter that "persons who are only selling storage devices used to hold private keys or persons who merely write software code are not carrying out broker activities."

Decentralized finance protocols

The traditional cost basis reporting framework relies on persons with knowledge of the cost basis and gross proceeds of transactions to report cost basis and gross proceeds information to their customers and to other brokers in the event of a transfer. One of the more unusual aspects of the cryptoasset market is its decentralized network and smart contract capabilities. These have allowed the creation of a burgeoning "decentralized finance" (DeFi) ecosystem, where parties transact peer-to-peer using "decentralized exchanges" (DEXs). Unlike the traditional stock and securities exchanges, in a digital asset transaction carried out on a DEX, software code — not a person or legal entity — stands between the parties to the transaction. Although this software was developed by people, it is usually decentralized and is not "owned" in the traditional sense.

The definition mentioned above of a digital assets broker as "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person" creates significant technical hurdles to requiring DEXs to provide cost basis reporting information. As defined, a broker is a "person." The term "person" is broadly defined for purposes of the Code by Sec. 7701(a)(1) to include an individual, trust, estate, partnership, association, company, or corporation. However, even that expansive definition does not include software. Assuming a DEX is not classified as a business entity (e.g., a partnership), it is not clear that DeFi protocols, as nonpersons, could be required to report transactions under the new statutory framework.

It also bears noting that DeFi protocols typically do not charge any fees to users — the fees that are charged are either paid to liquidity providers or network fees paid to miners/stakers, rather than paid to the protocol itself. Thus, it may be difficult for Treasury to make the case that a DEX is receiving consideration, which is another requirement for broker status.

On a more practical level, it is not clear how requiring DEXs to provide cost basis information to users could be implemented or enforced. Again, there typically are no real people who own a DEX who could be encouraged to comply by the threat of penalties for noncompliance. It is also noted that, although changes can be made to a DEX, it typically requires the holders of governance tokens to agree to the change. It may be difficult to secure sufficient support to implement a cost basis reporting infrastructure into a DEX, given the importance of anonymity to many users.

One could imagine, however, a scenario in which Treasury and other regulators could create a framework of adverse tax consequences for payments made through a DEX so as to (1) induce DEX

token holders to adopt reporting procedures when there are significant U.S. participants; or (2) incentivize a U.S. participant to seek out DEXs that provide reporting. In other information reporting areas, for example, an absence of information could lead to presumption rules that require withholding or taxation at the highest applicable rate.

Notwithstanding the significant roadblocks to DeFi reporting on both a technical and practical level, it is not yet clear that DeFi will be exempted. Admittedly, a cost basis reporting regime that excludes DeFi transactions would exclude a sizable portion of cryptoasset transaction volume and might fall short of the improved tax compliance that Congress envisioned. Also, it should be noted that DeFi was not specifically addressed as an area that should be excluded from reporting in previous public statements by members of Congress, and in an early draft of the Infrastructure Act digital assets reporting amendments that was circulated to industry participants, the broker definition referenced decentralized exchanges and peer-to-peer marketplaces. For its part, Treasury does not seem to have ruled out DeFi reporting, stating in its recent letter that it would “consider the extent to which other parties in the digital asset market, such as centralized exchanges and those often described as decentralized exchanges and peer-to-peer exchanges, should be treated as brokers. …”

Diabolical details

Although there are some encouraging signs from Treasury, there still exists considerable uncertainty as to the nature and scope of the cost basis reporting rules as they apply to digital assets. The devil will be in the details, and, hopefully, the forthcoming guidance will take a measured approach and consider the unique nature of the digital asset markets. Provisions of the Infrastructure Act will require brokers to monitor cost basis for digital assets acquired on or after Jan. 1, 2023, and report for tax year 2023 at the beginning of 2024. Given the extremely short time frame for implementation, Treasury should also consider delaying the implementation of digital asset cost basis reporting, particularly for market participants that might have reasonably expected they would not be subject to the requirements.

Editor Notes

Mary Van Leuven, J.D., LL.M., is a director, Washington National Tax, at KPMG LLP in Washington, D.C. For additional information about these items, contact Ms. Van Leuven at 202-533-4750 or mvanleuven@kpmg.com. Contributors are members of or associated with KPMG LLP.

The information in these articles is not intended to be “written advice concerning one or more federal tax matters” subject to the requirements of Section 10.37(a)(2) of Treasury Department Circular 230 because the content is issued for general informational purposes only. The information is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. The articles represent the views of the author or authors only, and do not necessarily represent the views or professional advice of KPMG LLP.