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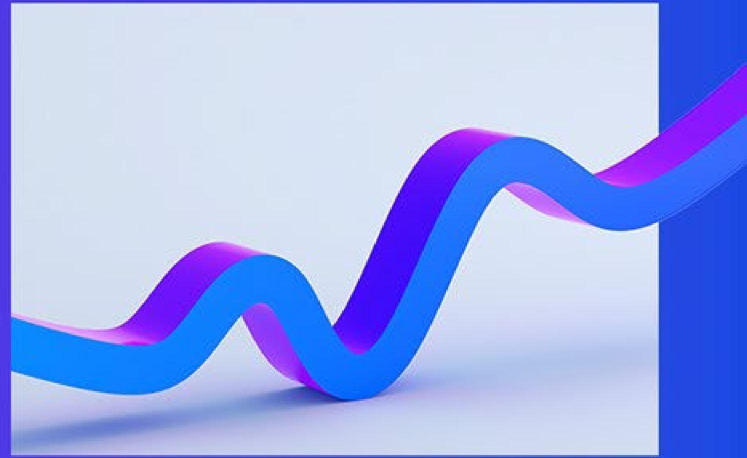

Impact of Proposed U.S. Broker Digital Asset Tax Reporting Regulations on Digital Asset Payment Processors

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This article highlights potential impacts of the proposed U.S. broker digital asset tax reporting regulations on Digital Asset Payment Processors.

The proposed regulations apply broker reporting on digital asset sales not only to trading platforms but also to businesses that facilitate the conversion of digital assets to fiat or another digital asset. The rules would also impact third-party settlement entities that act as payment intermediaries in marketplaces or similar platforms where cryptocurrency is accepted and would bring within scope of the reporting requirements certain payment card issuers when a card transaction involves payment in digital assets.

Since the IRS classifies digital assets as property, the act of paying for a good or service or other property with digital assets is treated as a disposition of the digital asset used for payment. The buyer of the goods or service is in effect selling that digital asset, and the reporting rules impose broker sales reporting on payment intermediaries in certain of these circumstances.

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This article is general in nature, and further assessment of the rules against a business's particular facts will need to be conducted to determined how the rules may apply in the context of that business. The new regulatory guidance as currently proposed is subject to change prior to finalization, but the proposed timeline for when these regulations would be effective is relatively short and thus industry participants may need to begin assessing their compliance needs against these proposed rules.

What are the broker crypto reporting regulations?

The U.S. Treasury and IRS released proposed regulations on August 25, 2023, that would, when finalized, require certain persons treated as "brokers" effecting sales of 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 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 intended purpose is to alert the IRS of taxpayers' digital asset sales and to provide taxpayers with tax-relevant information to complete their tax returns.

The package of proposed regulations is expansive in its coverage and brings into the broker reporting framework custodial digital asset trading platforms, certain decentralized exchanges and NFT marketplaces, digital asset payment processors, and certain real estate reporting persons.

The proposed regulations leverage off existing broker reporting regulations that apply to sales of stocks and securities but expand the scope of reporting brokers and the type of transactions that are reportable.

What businesses may be treated as Digital Asset Payment Processors that would be subject to the broker reporting regulations?

The proposed regulations contemplate three principal categories of persons that fall within the definition of a Digital Asset Payment Processor that could be required to conduct broker reporting on digital asset sales.

The first category includes a person who in the ordinary course of a trade or business stands ready to effect sales of digital assets by "[r]egularly facilitating payments from one party to a second party by receiving digital assets from the first party and exchanging those digital assets into a cash or different digital assets paid to the second party." For example, a payment processor that facilitates a merchant's acceptance of bitcoin or other cryptocurrency (including stablecoins) for its goods or services would be classified as a Digital Asset Payment Processor if the processor accepted the bitcoin or cryptocurrency from the merchant's customer for a purchase of goods from the merchant and paid the merchant the cryptocurrency's equivalent in cash.

The second category includes what are called third party settlement organizations (TPSOs). TPSOs generally act as payment intermediaries in marketplaces or platforms where there are a number of unrelated sellers or merchants. Customers on the platform pay the TPSO in order to purchase an item from one of the sellers on the platform, and the TPSO is obligated under its contractual arrangement with the sellers to settle each such purchase transaction. In this scenario, if the TPSO makes, or submits instructions to make, payments in digital assets in order to settle a transaction with a seller, the TPSO is also treated as a broker under these proposed regulations. Thus, if a customer purchasing goods from a seller pays 15 units of a cryptocurrency to buy the product and the TPSO gives instruction to the customer to send the 15 units of cryptocurrency to the seller's wallet, the TPSO is also required to report on the buyer's "sale" of those 15 units of cryptocurrency even though there is no conversion of the cryptocurrency into cash.

The third category of Digital Asset Payment Processors is a payment card issuer that facilitates payments, either by making or submitting instructions to make payments, in one or more digital assets to a merchant

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acquiring entity in a transaction that is associated with a payment made by the merchant acquiring entity, or its agent, in settlement of a reportable payment transaction. A merchant acquiring entity, in this context, is generally a merchant acquiring bank that has in place an arrangement with unrelated merchants providing standards and mechanisms for settling transactions with respect to payment cards that the merchant accepts. A card issuer would generally direct payment to the merchant acquiring bank in respect of a transaction executed via a card the card issuer issues and that the merchant accepts under its arrangement with the merchant acquiring bank.

Under this provision, a card issuer may be treated as a digital asset payment processor. This might happen where a card issuer issues a digital asset credit card to a customer. If the customer uses that card to purchase goods from a merchant that accepts the card via an arrangement with its merchant acquiring bank, then the card issuer could be treated as a broker. The card issuer would need to report on that payment if as part of the purchase transaction the card issuer makes or gives instructions to make payment in digital assets to the merchant acquiring bank.

How will Digital Asset Payment Processors be impacted by these regulations?

With respect to payments for goods and services, information reporting traditionally has been reserved to reporting transactions only to sellers. The proposed regulations now view a purchaser that uses a digital asset to pay for a good or service as a sale of the digital asset by that purchaser. Thus, one of the more significant impacts to Digital Asset Payment Processors is the shift to require reporting to purchasers in addition to existing requirements to report to sellers.

Of note, the proposed regulations include an additional rule where one party (*e.g.*, purchaser) directly transfers a digital asset to a second party (such as a vendor of goods or services) pursuant to a processor agreement between the second party (vendor) and a payment processor. A processor agreement in this case would be an agreement between the vendor and the payment processor that facilitates the payment from the purchaser to the vendor by providing for a temporary fixing of the exchange rate to be applied to the digital asset received by the vendor from the purchaser in the transaction. The proposed regulations would treat the payment in this scenario as if the purchaser first paid the digital asset to the payment processor in exchange for cash or a different digital asset that is paid to the vendor and thus would be an in-scope transaction. The processor in this case becomes a Digital Asset Payment Processor.

Digital Asset Payment Processors treated as effecting sales of digital assets under the proposed regulations would generally be expected to document for tax purposes purchasers or payors (“customers”) in these transactions, report on sales of digital assets by U.S. or presumed U.S. customers to both the IRS and the payor, and conduct backup withholding on proceeds for customers who have no (or invalid) documentation and are presumed to be U.S. individuals or other persons not exempt from reporting.

If the payment processor falls within the reporting framework set out by the proposed regulations, the processor will need to review its processes or consider new processes for tax onboarding (obtaining and validating tax documentation), recording transactional information (*e.g.,* sale date and time, asset sold, wallet address of seller, etc.), and reporting to both the IRS and the payor. In-scope entities will also need to design and implement a process to backup withhold on proceeds of sales of digital assets.

What information would Digital Asset Payment Processors need to report?

Reportable digital asset sales include the payment scenarios outline in Sections 2 and 3 above. For reportable sales, the information to be reported under the proposed regulations extends beyond the data sets that brokers may have for traditional securities.

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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 hosted wallets
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. Information is also to be provided with respect to what the sale of digital asset is exchanged for. These are data elements particular to digital asset transactions that we do not see in the traditional financial services area.

The proposed regulations also generally require brokers to report certain information relating to transfers that have been made into a wallet if the wallet is hosted with the payment processor. If the digital asset treated as sold was transferred into such an account/wallet on a prior occasion, then information relating to that transfer is also to be reported under the proposed regulations.

In certain cases, 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). This may potentially apply to custodial brokers that also offer digital asset payment cards linked to the hosted wallet or payment processors that allow for hosting of customer digital assets.

Because some digital asset payment processors may also be classified as third-party settlement organizations (TPSOs) with respect to sellers on a marketplace or similar platform, digital asset payment processors may also need to report aggregate sales to sellers on a Form 1099-K. This reporting to sellers for payment for goods and services would follow existing reporting requirements for TPSO payments so long as the goods sold are not digital assets. The TPSO Form 1099-K reporting requirements differ significantly from those for broker reporting, in particular TPSO reporting is generally of the aggregate gross amount paid to the seller for the year rather than transaction-by-transaction reporting.

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

There are numerous operational challenges that the proposed regulations raise with respect to the reporting process, which include the following:

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Customer Relationship: In certain cases, payment processors may have a relationship with merchants or sellers but may not have a relationship with a purchaser (customer of the merchant). Where there is no customer relationship from a business standpoint, it may be difficult to implement infrastructure for tax documentation solicitation, backup withholding and reporting for “customers” whose transactions may be sporadic or even single-transaction events.

Transaction-by-Transaction Reporting: For Digital Asset Payment Processors that currently report to merchants or sellers (such as TPSOs) with respect to gross amounts of payments paid to sellers in aggregate for the year, they do not only need to shift to reporting for purchasers but will need to do on a transaction-by-transaction basis. Each payment of digital currency would be a separate sale that needs to be reported separately under broker reporting rules.

Differentiating Digital Asset vs Non-Digital Asset Sales by a Seller: In a marketplace context, where both digital assets and non-digital assets are sold, the proposed regulations would result in two different types of reporting to merchants. Broker transaction-by-transaction reporting would be required for the sale of digital asset (e.g., on a form similar to Form 1099-B), whereas Form 1099-K reporting would be required on the sale of non-digital assets. This would require systems to differentiate the two types of assets and apply different reporting rules and processes to reporting sales possibly by the same merchant. Systems will need to coordinate between broker reporting and Form 1099-K reporting to sellers.

Gross Proceeds Determination and Order Flow: There are various events that occur with payment for goods and services, including the order, receipt of payment by the payment processor, disbursement of funds to the seller, the possibility of cancellations, chargebacks, refunds and offsets. Digital Asset Payment Processors will need to analyze these events and the timing of these events as well as the underlying contractual arrangement to determine gross proceeds based on fair market value of the digital asset deemed sold. Where digital assets are being exchanged for other digital assets and not based on a contractual fixed exchange rate between digital asset and fiat, understanding the timing of the sale and being able to access a fair market value price would be an additional challenge. Processors will also need to understand procedures to have in place for order cancellations, refunds, etc.

No De Minimis Threshold: There is no de minimis threshold for which reporting would not be required. This means that even relatively small transactions, e.g., purchase of a cup of coffee, may require reporting. This increases the population of persons subject to reporting, overall reporting volume and a larger population from whom tax documentation will need to be solicited and maintained.

To whom does Digital Asset Payment Processor need to report? Are there exclusions from reporting?

Generally, the proposed broker reporting regulations require reporting to “customers” (which for a Digital Asset Payment Processor would translate to a purchaser or payor) 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. But individuals or those presumed to be individuals are not exempt recipients nor are partnerships.

To the extent that a Digital Asset Payment Processor 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. person and a Form W-8 from a non-U.S. person. There are situations such as for a Digital Asset Payment Processor 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 the U.S. Treasury) to utilize certain documentary evidence (such as passports) to substantiate non-U.S. status.

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There is also an exclusion from reporting for certain non-U.S. Digital Asset Payment Processors (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 customer's 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.

Finally, if no documentation has been provided by a user or the documentation provided is invalid or has expired, there are presumption rules that would allow a Digital Asset Payment Processor to presume the status of the user for reporting purposes. These rules will often presume the user to be a U.S. non-exempt recipient subject to reporting (in which case, as discussed further below, backup withholding may also apply).

Are there other significant aspects of these regulations that a Digital Asset Payment Processor should be concerned with?

One of the other challenges with information reporting given the proposed regulations beyond those discussed above is that there is little guidance on application of withholding and reporting rules where there is a U.S. source payment made to a non-U.S. person. For non-U.S. customers, certain transactions may give rise to payments that may be treated as U.S. source and therefore result in required withholding and reporting under the nonresident alien withholding tax rules and Form 1042-S reporting framework.

The U.S. is also currently contemplating whether it would join the OECD Crypto Asset Reporting Framework (CARF) for global tax information exchange with respect to digital assets. If it does, a marketplace's systems may need to be modified to account for any changes made to these proposed regulations to integrate CARF, or other potential information reporting requirements imposed directly under CARF.

The other significant operational issue that will need to be addressed is what is known as "backup withholding" (discussed below).

What is backup withholding?

One of the enforcement mechanisms for domestic reporting is that if an account holder/customer does not provide valid documentation, either that the account holder is a U.S. person (with a tax identification number on a Form W-9) or a documented non-U.S. person, presumption rules may act to treat the account holder as an undocumented U.S. person subject to reporting. In such case, the broker is also required to backup withhold on proceeds at the rate of 24% and deposit this tax with the IRS.

The rationale behind this backup withholding mechanism is to incentivize brokers to collect and customers to provide tax documentation necessary for reporting that would allow the IRS to associate the proceeds with a particular taxpayer (if U.S.).

There is an exclusion for non-U.S. digital asset brokers (including payment processors) and controlled foreign corporation digital asset brokers, in each case not engaged in a money services business, that allows such persons not to backup withhold in this circumstance unless they have actual knowledge the customer is a U.S. person. If a payment processor is registered as a money service business with the U.S. Treasury, as may be the case, this exception would not apply.

Backup withholding systems can be complicated to implement especially in a Digital Asset Payment Processor context where the payment processor may not have a business relationship with the purchaser since there is no real "account" to backup withholding against. To conduct backup withholding on the digital asset payment itself would require liquidation of the digital asset to pay the backup withholding tax, which would presumably negate the purchase transaction since the remaining payment would not meet the purchase price.

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

There are numerous actions that a Digital Asset Payment Processor can proceed with now even though the regulations are still proposed:

- 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.
- Draft comments to the proposed regulations on issues that matter to the business (deadline is October 30, 2023, but likely the IRS would consider additional industry feedback prior to finalization of the regulations).
- Educate key stakeholders in the business about the proposed regulations because they may be needed to implement compliance systems but also because they may understand better than practical and technological operations of the platform that could influence the applicability of certain of the reporting rules to the business or how the existing systems may influence the design of the compliance framework.
- For Digital Asset Payment Processors that likely will fall into the reporting category, more assessment as readiness of systems and processes:
  - What infrastructure is in place currently for information reporting, e.g., for sellers and can that infrastructure be modified to accommodate reporting for purchasers?
  - Discuss with stakeholders who would be responsible for business requirements and implementation.
  - Consider whether it is feasible to build compliance systems internally or to work with an outside vendor.
  - Coordinate with other reportable payment events other than digital asset sales, in particular reporting currently required on Form 1099-K and Form 1099-NEC.

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