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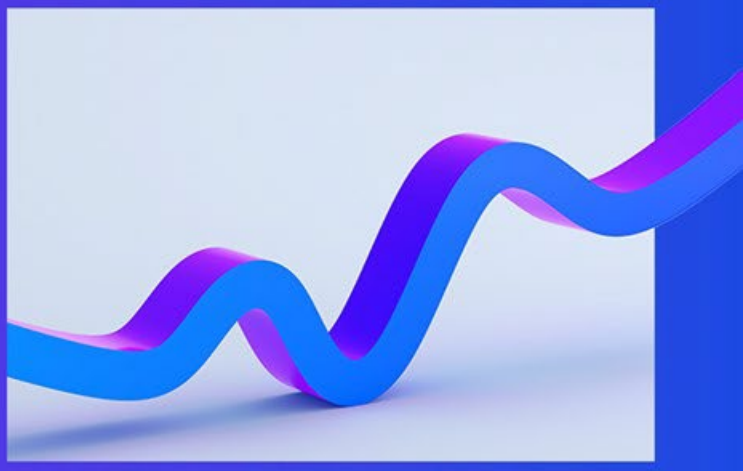

Backup Withholding for U.S. Digital Asset Brokers

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This article provides a discussion of what backup withholding means in the broker digital asset reporting framework under the final U.S. broker digital asset reporting regulations published in the Federal Register on July 9, 2024. It provides an overview of the concept of backup withholding and the transitional relief rules provided by the U.S. Internal Revenue Service (IRS) in the regulations and a separate Notice 2024-56.

What is the Backup Withholding Tax?

The Internal Revenue Code under Section 3406(a)(1) requires certain payors of reportable payments (i.e., generally Form 1099 reportable payments) to deduct and withhold a tax on a payment at the statutory backup withholding rate if the payee fails to furnish the payee's taxpayer identification number (TIN) to the payor in the manner required. The statutory withholding rate is currently at 24 percent and this tax is known as the backup withholding tax.

Thus, for example, in the traditional broker securities reporting context, if a brokerage account customer is an individual and does not provide a TIN to the broker on Form W-9 that is certified as correct under penalties of perjury, then the broker is responsible for deducting 24 percent of proceeds of a reportable sale effected for such customer by the broker and deposit the amount with the IRS. If the sales proceeds were $100, $24 would need to be deducted from the proceeds and deposited with the IRS under prescribed schedules. A broker that fails to backup withhold correctly may be liable for the amount of required backup withholding as well as late deposit penalties.

The final broker digital asset reporting regulations treat gross proceeds from certain sales of digital assets as reportable payments and backup withholding can be triggered if a customer fails to provide a certified TIN to the broker (as explained below).

There are certain persons that are considered low risk for tax avoidance and are exempt from reporting (e.g., C corporations, tax-exempt organizations, etc.), known as “exempt recipients.” Exempt recipients under the final regulations also include U.S. digital asset brokers that certify to their status on a Form W-9 or separate statement. In addition, documented non-U.S. persons, called “exempt foreign persons” in Treasury regulations, are also currently exempt from Form 1099-DA reporting. To be an exempt foreign person, the customer must generally provide required tax documentation (e.g., a Form W-8BEN for individuals). If a customer is exempt from reporting, they are also exempt from backup withholding, although for broker backup withholding purposes, de minimis thresholds for reporting are disregarded in determining whether a payment is subject to reporting.

If these exemptions do not apply and a payment (e.g., gross proceeds on the sale of a digital asset) is reportable, the broker’s customer must provide the TIN, together with certain certifications with respect to the TIN under penalties of perjury, to the broker or otherwise be subject to backup withholding. This certified TIN is generally provided on a Form W-9 or an acceptable substitute. In part, the certification requires signature under penalties of perjury that the TIN is correct. Backup withholding can also apply under certain special procedures if the IRS notifies a broker that a payee has a name and TIN mismatch based on a prior return filing and the mismatch is not corrected pursuant to what are called “B Notice” procedures.

For broker proceeds, the application of backup withholding can have significant impact. The backup withholding tax at 24 percent applies to the gross proceeds and not just on gains on sale. The backup withholding tax can be applied as a credit against tax owed by a customer, but the customer would require appropriate documentation relating to the tax withheld to claim the credit on their tax return.

Moreover, the backup withholding process can be complicated in the digital asset space since reportable sales of digital assets include not only sales for cash but sales of digital assets for other digital assets or property or services. Thus, property received in an exchange of one digital asset for another digital asset may need to be liquidated to obtain funds for backup withholding.

Furthermore, since impacted brokers may have existing customers who may not have provided TINs or certified TINs in the past, brokers will likely need to solicit tax documentation not only for new customers but for the population of existing customers. The process of educating customers about the need to provide tax forms and to solicit, validate, and sometimes cure the forms received can be a lengthy process.

Given these considerations, the U.S. Treasury Department and the IRS have provided certain relief provisions with respect to backup withholding on digital asset sales, some of which are transitional in nature. The relief provisions are contained principally in Notice 2024-56 but also, in part, in the final broker digital asset reporting regulations.

No Backup Withholding for Calendar Year 2025

Under the final broker digital asset reporting regulations, reportable sales of digital assets include sales effected on or after January 1, 2025. However, Notice 2024-56 provides that backup withholding would not be required for sales of digital assets effected in calendar year 2025. This provides a one-year general relief from the backup withholding rules for digital asset sales.

The IRS noted that “brokers may not have enough time to obtain a certified TIN from a payee prior to the date of a digital asset sale by that payee during 2025 that is subject to reporting.” Consequently, the U.S. Treasury and the IRS provide a general exemption from backup withholding on broker reportable digital asset sales “to provide brokers with additional time to develop appropriate procedures for collecting certified TINs from customers and to otherwise comply with the backup withholding requirements on digital asset sales.”

Transition Rules for 2026

There are also several transitional rules that apply for calendar year 2026.

First, for reportable digital asset sales effected in calendar year 2026, the IRS will permit brokers to rely on TINs provided by customers that are not certified if those uncertified TINs were provided by customers that opened accounts with the broker prior to January 1, 2026, (preexisting customers) and if the broker, prior to effecting the digital asset sale transaction:

- Submits the payee's name and TIN combination to the IRS's TIN Matching Program and
- Receives a response that the name and TIN combination furnished by the payee matches the name and TIN combination for that payee in the IRS records.

Thus, if these criteria are met, no backup withholding would apply to the digital asset sale occurring in calendar year 2026, even if the TIN is not a certified TIN (e.g., there is a TIN in the broker's records for the customer but there is no associated signed Form W-9 or substitute with required certifications on file).

Second, the final Treasury regulations also provide a presumption that certain preexisting customers can be treated as exempt foreign persons (and therefore exempt from reporting and backup withholding). Treas. Reg. § 1.6045-1(g)(4)(vi)(F) treats preexisting customers as exempt foreign persons with respect to digital asset sales effected prior to January 1, 2027, as an exempt foreign person if:

- The customer has not been previously classified as a U.S. person by the broker and
- The information the broker has for the customer includes a residence address that is not a U.S. address.

For example, if a broker's customer has not provided a TIN to the broker and the account was opened prior to January 1, 2026, and the broker has an address for the customer in the U.K., the broker would not have to report or backup withhold on the customer with respect to the customer's digital asset sales occurring before January 1, 2027. This will mean that neither reporting nor backup withholding would apply for the customer for calendar years 2025 and 2026.

Transitional Relief for Digital Asset for Digital Asset Exchanges

The exchange of one digital asset for another digital asset raises practical challenges to backup withholding. If proceeds are in the form of another digital asset and there is no other source of funds available for backup withholding, the digital asset received may need to be liquidated to comply with backup withholding and deposit rules. Usually, the amount of proceeds is determined based on the fair market value of the assets at the time of the transaction, which may differ when the asset is liquidated due to asset price fluctuations.

Recognizing this challenge and to provide brokers additional time to develop appropriate procedures, Notice 2024-56 provides that the amount of "backup withholding tax required to be withheld and paid as a tax under section 3406 shall be limited to the amount that the broker receives upon the liquidation of 24 percent of the customer's received digital assets, notwithstanding that such amount may be less than 24 percent of customer's received digital assets at the time of the transaction giving rise to the backup withholding obligation …." However, it is a requirement for this relief provision to apply that the liquidation "is undertaken immediately after the transaction giving rise to the backup withholding liability." The Notice notes that, for this purpose, "a broker that systemically liquidates the received digital assets when received as part of its process to perform the underlying sale transaction will be treated as immediately liquidating the received digital assets."

This is a transitional relief provision that applies only to reportable digital asset sales effected before January 1, 2027.

Specified NFTs, Real Property Sales and Payment Processor Transactions

Finally, there are several types of transactions which the U.S. Treasury and the IRS have determine will not be subject to backup withholding until further guidance.

First, recognizing that a real estate reporting person may not always have possession of the digital assets utilized by a buyer to make payment in a reportable real estate transaction, backup withholding is not required on any digital asset for real property sale effected by a real estate reporting person until further guidance is issued.

Second, the Notice indicated that the Treasury and the IRS were aware that processors of digital asset payments (PDAP) "generally do not take custody of the proceeds, for example goods or services acquired with digital assets, and as such may experience difficulties deducting and withholding the backup withholding tax." Accordingly, the Notice also states that backup withholding is not required on any PDAP sale effected by a PDAP until further guidance is issued.

Finally, the Notice exempts from backup withholding a reportable sale of a "specified NFT" until further guidance is issued. For this purpose, a specified NFT means a digital asset that is (A) indivisible (cannot be subdivided into smaller units without losing its intrinsic value or function); and (B) unique (digital asset itself includes a unique digital identifier, other than a digital asset address, that distinguishes that digital asset from all other digital assets); (C) is not and does not provide the holder any interest in certain "excluded property" including a security or commodity. This relief provision addresses the challenge of liquidating property that is by its very nature indivisible.

Concluding Thoughts

To implement backup withholding procedures, systems will need to understand both transactions that are reportable (regardless of de minimis thresholds) as well as the documentation status of the customer/payee. Moreover, the relief provisions and exemptions will need to be layered on top of the general rules, with the understanding that certain relief provisions are transitional and others are not. In addition, processes will need to take into account digital asset for digital asset exchanges and how backup withholding can be implemented in those cases.

Thus, while there is relief for backup withholding in 2025, it is important that brokers begin assessing the current state of customer tax documentation and the reporting framework and initiate the design, implementation and testing of backup withholding procedures and processes to integrate with these other compliance functions.

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