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Closed Loop Transactions vs Limited Access Regulated Networks Under the Final Broker Digital Asset Reporting Regulations

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The final U.S. broker digital asset reporting regulations published in the Federal Register on July 9, 2024 (the final regulations) provide exceptions to reporting for certain sales of digital assets involving closed loop transactions. The final regulations also provide a separate exception to the rules requiring that dual classification assets be reported as digital assets if those dual classification assets are settled on a limited-access regulated network. This article explores the nuances of both and explains the difference between the two.

Closed-Loop Transactions as Excepted Sales

A closed-loop digital asset is a type of virtual currency that can only be used as payment within a particular virtual environment. As an example, there are online games whereby users earn online virtual currency and are able to purchase and exchange virtual assets only within those specific games or communities. These virtual assets are used solely within the in-game world and cannot be sold or exchanged for fiat (cash) outside of the game.

The Treasury Department (Treasury) and the Internal Revenue Service (IRS) did not intend for the broker reporting regulations to apply to virtual assets that exist only in a closed systems and that cannot be sold or exchanged outside of that system for fiat currency (e.g., credit card points). After receiving comments from industry participants, the final regulations provide an exception for sales within these closed-loop systems. Treasury and IRS cautioned that this exception for closed-loop assets does not create an inference that the

transaction itself is a sale of digital assets, but rather that information reporting on these transactions is not appropriate at this time.¹

During the comment period, industry groups provided examples of closed-loop assets that are not capable of being sold or exchanged outside of the closed environment. In addition to three very specific closed-loop transactions for which reporting is not required, the final regulations include a more general exception for “other transactions.” Treasury and IRS did not intend for this treatment as an excepted sale to be broadly applicable to any digital asset sold within a permissioned distributed ledger network and indicated caution in creating a broader exception. Treasury and IRS, however, appeared open to augmenting the list of excepted sales to include any other similar digital assets that cannot be sold or exchanged outside of the controlled, permissioned ledger, and that do not raise new tax compliance concerns.

Exception for ‘other transactions.’ This limited class of digital assets must be offered by a seller of goods or provider of services to its customers and exchangeable or redeemable only by those customers for goods or services provided by such seller or provider, and not by others in a network. The digital asset must not be capable of being transferred, exchanged, or otherwise used outside the cryptographically secured distributed ledger network of the seller or provider and also may not be sold or exchanged for cash, stored value cards, or stablecoins at market rate inside the seller or provider’s distributed ledger network. This capability of being “sold, transferred, exchanged, or otherwise used” outside of the closed environment carries over into the following three more specific exceptions.

Dispositions of nonfungible tokens (NFTs) used by loyalty programs. Transactions involving dispositions of a digital asset representing loyalty program credits or loyalty program rewards are excepted sales for which reporting is not required. Similar to the “other transactions” exception, the digital asset must be offered by a provider of non-digital asset goods or services to its customers in exchange for non-digital asset goods from the provider or other merchants participating with the developer as part of the program. Under the final regulations, this exception is limited to programs that do not permit customers to transfer, exchange, or otherwise use the tokens outside of the closed (permissioned) distributed ledger network of the program.

Video game tokens with limited uses. Dispositions of video game tokens that are not capable of being transferred, exchanged, or otherwise used outside the closed distributed ledger environment are excepted sales for which reporting is not required. Owners of video game tokens with limited ability to sell outside the video game environment do not indicate a high risk of noncompliance. To meet this exception, the dispositions of video game tokens must not be capable of being transferred, exchanged, or otherwise used outside the closed distributed ledger environment.

Transfers within a fixed network of banks. The final regulations provide a reporting exception for certain transactions within a single cryptographically secured distributed ledger, or network of interoperable distributed ledgers. Because these digital assets do not have real value, they are essentially a recordkeeping tool and are not transferable for cash or other digital assets outside of the closed system.

Treasury and IRS were careful not to exclude these types of transactions from the definition of digital assets, because of the potential for creating an exception for other digital assets that could be involved in transactions that could give rise to taxable gain or loss. Instead, they are on the list of excepted sales for which reporting is not required with conditions. The exception applies to transactions involving digital representations of assets that may be transferred only within a fixed network of banks using permissioned distributed ledgers to communicate payment instructions or other back-office functions because bank networks use digital assets as part of a messaging service (*e.g.*, they represent payment instructions or the management of nondigital asset inventory). To maintain excepted sale status, these sales must not give rise to sales of other digital assets

¹ Pending additional details from industry participants that there may be instances of closed loop assets that are capable of being sold, transferred, exchanged, or otherwise used outside of the closed environment.

within the network of interoperable distributed ledgers and the digital assets disposed of cannot be being transferred, exchanged, or otherwise used, outside such distributed ledger or network.

This exception does not apply to sales of digital assets that are also sales of securities or commodities that are cleared or settled on a limited-access regulated network, which is a separate and distinct coordination rule for dual classification assets.

Dual Classification Assets Cleared or Settled on a Limited-Access Regulated Network

Both the pre-2024 final regulations and the final regulations (2024) require reporting with respect to sales for cash of securities and certain commodities. Transactions that involve the sale of a digital asset that also constitutes the sale of a commodity or security are dual classification assets. Generally, the final regulations provide that a broker must treat a sale of a dual classification asset as a sale of a digital asset reportable on Form 1099-DA and only as a sale of a specified security that is a digital asset.

Treasury and IRS did not want to disrupt reporting on dual classification assets that are treated as digital assets, because distributed ledger technology is used solely to facilitate the processing, clearing, or settlement of orders between regulated financial entities. To accommodate this, the final regulations add an exception² to the coordination rule for any sale of a dual classification asset that is a digital asset solely because the sale of such asset is cleared or settled on a limited-access regulated network. Under this exception, the sale is reported on Form 1099-B and not as a digital asset reportable on Form 1099-DA. Such a sale must be treated as a sale of a specified security to the extent applicable, and not as a sale of a specified security that is a digital asset. For all other purposes including transfers, a dual classification asset that is a digital asset solely because it is cleared or settled on a limited-access regulated network is not treated as a digital asset and is not reportable as a digital asset.

This exception is limited to dual classification assets that are digital assets solely because the sale of such dual classification asset is cleared or settled on a limited-access regulated network. A digital asset commonly referred to as a cryptocurrency that fits within the definition of a commodity under the final regulations because the trading of regulated futures contracts in that digital asset have been approved by or certified by the Commodities Futures Trading Commission (CFTC) will not be eligible for this rule because the cryptocurrency meets the definition of a digital asset for reasons other than because it is cleared or settled on a limited-access regulated network.

The final regulations set forth three types of limited-access regulated networks for which this rule applies.

Network of interoperable distributed ledgers. One type of limited-access network is a cryptographically secured distributed ledger or network of interoperable distributed ledgers that provide clearance or settlement services and provide access only to a group of persons made up of registered dealers in securities or commodities, banks and similar financial institutions, common trust funds, or futures merchants. An interoperable ledger means a group of distributed ledgers that permit digital assets to travel from one permissioned distributed ledger to another permissioned distributed ledger. In other words, from one securities broker to another securities broker. While the clearance or settlement of the dual classification asset is on a network of permissioned distributed ledgers, it is anticipated that the asset will remain in a

² There are three exceptions to the rules requiring that dual classification assets be reported as digital assets, which apply to dual classification assets cleared or settled on a limited-access regulated network, to dual classification assets that are section 1256 contracts, and to dual classification assets that are shares in money market funds.

traditional securities or commodities account from the perspective of an investor in the asset and so can readily be reported as a security or commodity under existing rules.

Network provided by a Securities and Exchange Commission (SEC) registered or exempt entity. This type of limited-access network is similar to the first; however, it is provided by an entity that has registered with the SEC a clearing agency or has received an exemption order from the SEC as a clearing agency, under section 17A of the Securities and Exchange Act of 1934. Access to the network must be provided exclusively to network participants, who are not required to be registered dealers in securities or commodities, banks, and similar financial institutions, common trust funds, or futures commission merchants. Treasury and IRS anticipate that typical participants, however, will be securities brokers and other regulated financial institutions. As an example, dual classification assets cleared and settled through a central clearing agency that clears and settles high volumes of equity and debt transactions on a daily basis through automated systems for participants that are financial market participants may be reportable as securities under this exception if the clearance or settlement takes place on a cryptographically secured distributed ledger or network of interoperable distributed ledgers.

Network controlled by a single registered dealer. This type of limited-access regulated network is a cryptographically secured distributed ledger controlled by a single person that is a registered dealer in securities or commodities, a futures commission merchant, a bank or similar financial institution, a real estate investment trust, a common trust fund, or a 1940 Act Fund, that permits the ledger to be used solely by itself and its affiliates (and not to any customers or investors) to clear or settle sales of assets. It is anticipated that from an investor perspective, the assets will remain in a traditional securities or commodities account.

KPMG Observations

The reporting exceptions for closed loop transactions and the dual classification assets on a limited access network involve two different sets of rules. The overarching theme seems similar, as it applies to closed or regulated environments; however, the application is quite different. Industry participants should use caution when applying each to their businesses.

- Both appear to provide an exception to broker reporting of digital asset transactions
 - Closed-loop transactions may not be reportable on Form 1099 in general
 - Dual classification assets on a limited-access regulated network must be reported on Form 1099-B instead of Form 1099-DA
- Both discuss closed environments
 - Closed-loop transactions are not capable of being sold, transferred, exchanged, or otherwise used outside of the closed environment
 - Dual classification assets on a limited-access regulated network are digital assets solely because distributed ledger technology is used to facilitate the processing, clearing, or settlement of orders between regulated financial entities.

As brokers begin implementing a process for reporting digital assets, they may need to document a methodology for determining that they are a closed loop environment with closed loop assets and transactions or whether they have dual classification assets in a limited-access regulated network. They will need to identify the specific exception under which they apply and demonstrate that the appropriate reporting has occurred. Although many dual classification assets have already been subject to reporting under the pre-2024 regulations, redefining those assets as such may involve a new process to document that the parameters of the limited-access regulated network provisions are indeed applicable. Brokers may want to consider how they will record these new classifications and exceptions and document more detailed process for identifying and tracking which digital assets are or are not being reported under the pre-2024 rules and the final 2024 regulations.

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