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Stablecoins Under the Final Digital Asset Reporting Regulations

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> This article provides an overview of stablecoins that are within the definition of digital assets under the final U.S. broker digital asset reporting regulations published in the Federal Register on July 9, 2024 (the final regulations), the optional reporting method for qualifying stablecoins, de minimis thresholds, and backup withholding.

What are stablecoins?

Stablecoins are digital representations of value that are recorded on cryptographically secured distributed ledgers. They are generally designed to have a stable value relative to another asset or assets and achieve this by pegging their price to another referenced asset. Stablecoins can take many forms:

- They can be backed by several types of assets (e.g., fiat currency, commodities, or other financial instruments or digital assets)
- They can be used in connection with transactions involving other types of digital assets
- They can be held and transferred in the same manner as other digital assets
- They do not have to be fully collateralized or supported fully by reserves by the underlying asset
- They do not have to have a constant value

Although stablecoins are designed to provide less volatility risk than other digital assets, the final regulations do not treat them like cash, even if their value is pegged to a fiat currency. Treasury and the Internal Revenue Service (IRS) believe that reporting sales of stablecoins will provide important information, so they chose not to exclude stablecoins from the definition of digital assets. Instead, the final regulations carve out a subset of stablecoins that do not fluctuate in value. These “qualifying stablecoins” are subject to special rules in the regulations.

Carveout for a qualifying stablecoin

The final regulations provide a tailored exemption for sales of qualifying stablecoins. In lieu of requiring a broker to report gross proceeds and basis on stablecoin sales under the transactional reporting rules, the broker may report designated sales of qualifying stablecoins under an alternative reporting method that allows for reporting on an aggregate basis. Given the high volume of stablecoin transactions and the fact that most of these transactions involve little or no gain or loss, this optional reporting method is intended to alleviate unnecessary and burdensome reporting.

The term 'qualifying stablecoin' is defined in the final regulations as any digital asset that meets the following three conditions for the **entire calendar year**:

- **Designed to track certain other currencies**. The digital asset must be designed to track on a one-to-one basis a single convertible currency issued by a government or a central bank.
- **Stabilization mechanism**. The digital asset must use one of the following two stabilization mechanisms:
  - Results focused test. The stabilization requirement is met if the stabilization mechanism causes the unit value of the stablecoin not to fluctuate from the unit value of the convertible currency it was designed to track by more than 3 percent over any consecutive 10-day period, determined using Coordinated Universal Time (UTC), during the calendar year. This stabilization mechanism provides design flexibility because it does not turn on how a digital asset maintains a stable value relative to a fiat currency, so long as it does; or
  - Design-focused test. The issuer of the digital asset must be required by regulation to redeem a unit of the digital asset at any time on a one-to-one basis for the same convertible currency that the digital asset was designed to track. This provides more certainty to brokers at the time of transaction. A stablecoin that satisfies this second stabilization mechanism includes key requirements set forth in the specified electronic money product definition under the Crypto-Asset Reporting Framework (CARF). As such, it is anticipated that this definition will be considered when the regulations are drafted to implement CARF. Note however, that many jurisdictions currently do not have regulations requiring an issuer to redeem a unit of the digital asset at any time on a one-to-one basis.
- **Accepted as payment**. The digital asset must be accepted generally as a payment by persons other than the issuer. This acceptance requirement would be met if the digital asset is accepted by the broker as payment for other digital assets or is accepted by a second party. As an example, acceptance by a merchant pursuant to a sale effected by a processor of digital asset payments (PDAP).

Designated sale of a qualifying stablecoin. The phrase "designated sale of a qualifying stablecoin" means any sale of a qualifying stablecoin other than a sale of a qualifying stablecoin in exchange for a different digital asset that is not a qualifying stablecoin. This includes the delivery of a qualifying stablecoin pursuant to the settlement of any executory contract which would be treated as a designated sale of the qualifying digital asset if the contract had not been executory, e.g., a forward, futures, or option contract.

A broker reporting under the optional method is not required to report sales of qualifying stablecoins that are non-designated sales of qualifying stablecoins under either the optional method or the transactional reporting rules. As an example, if a customer uses a qualifying stablecoin to buy another digital asset that is not a qualifying stablecoin, no reporting would be required if the broker is using the optional reporting method for qualifying stablecoins.

Optional reporting method rules

The optional reporting method allows aggregate reporting of all proceeds from sales of qualifying stablecoins for cash or other stablecoins that exceed a de *minimis* threshold that is discussed in the next section. Brokers that want to use this reporting method in place of transactional reporting are not required to submit any form or otherwise make an election to be eligible to report in this manner. Brokers that do not use this alternative reporting method must report sales of stablecoins under the same rules as for other digital assets.

If the aggregate gross proceeds reportable exceed $10,000, reporting is required with respect to each qualifying stablecoin for which there are designated sales even if the aggregate gross proceeds for a particular qualifying stablecoin does not exceed $10,000. A broker reporting under the aggregate reporting method must report the information described below with respect to designated sales of each qualifying stablecoin on a separate Form 1099-DA.

When utilizing the optional reporting method, a broker may report sales of qualifying stablecoins for some or all of its customers. The method chosen for a particular customer must be applied for the entire year for that customer's sales.

For designated sales of each type of qualifying stablecoin, a broker reporting under this method must report the following information on Form 1099-DA:

- Name, address, and taxpayer identification number (TIN) of the customer
- Name of the qualifying stablecoin sold
- Aggregate gross proceeds for the year from designated sales of the qualifying stablecoin (after reduction for the allocable digital asset transaction costs)
- Total number of units the qualifying stablecoin sold in designated sales of the qualifying stablecoin
- Total number of designated sale transactions of the qualifying stablecoin
- Any other information required by the form or instructions

Brokers must report under either the transactional method or under the optional reporting method. Failure to report under either method will result in penalties for failure to file information returns under the transactional method.

De *minimis* thresholds

$10,000 threshold for qualifying stablecoin sales

With respect to qualifying stablecoin sales, the final regulations adopt a $10,000 overall annual *de minimis* threshold. If a customer's aggregate gross proceeds (after reduction for the allocable digital asset transaction costs) from all designated sales of qualifying stablecoins do not exceed $10,000 for the year, a broker using the optional reporting method is not required to report on those sales. For sales in excess of this amount, a broker may report on an aggregate basis rather than on a transactional basis.

The final regulations provide helpful examples of how the *de minimis* thresholds will work. One includes a broker that provides services to a customer that is a U.S. non-exempt individual. The broker effects the following sales on behalf of the customer:

- Sale of $1,000 units of X in exchange for cash (designated sale)
- Sale of 5,000 units of X in exchange for Y, with a value of $5,000 (designated sale)
- Sale of 10,000 units of X in return for Z, with a value of $10,000 (non-designated sale)
- Sale of 3,000 units of Y in exchange for cash of $3,000 (designated sale)

Because the designated sales of X and Y did not exceed $10,000, the broker is not required to report any qualifying stablecoin sales for the customer. The $10,000 of gross proceeds from the sale of X for Z which is not a qualifying stablecoin is not included in this calculation to determine if the *de minimis* threshold has been exceeded because that sale is not a designated sale and as such is not reportable.

The broker would have to make two returns of information if it effected an additional sale of 4,000 units of Y in exchange for cash of $4,000 on behalf of the customer (designated sale).

In this case, the designated sales of qualifying stablecoins resulted in total gross proceeds of $13,000 ($9,000 from the original example and this new $4,000). Because the designated sales of all types of qualifying stablecoins exceeds $10,000, the broker must make two returns of information. One is for all of the customer's designated sales of X and another for all of the customer's designated sales of Y.

For joint accounts, the final regulations follow the general rules for determining which joint account holder's name and TIN should be reported on the information return. If two or more individuals own a joint account, then the first named individual on the account will be treated as the account.

Processors of digital asset payments (PDAPs)

This $10,000 *de minimis* threshold for qualifying stablecoins also applies to PDAPs that choose to report qualifying stablecoin transactions under the optional method, which will eliminate reporting of many small dollar purchases made using PDAP services. To avoid having to apply multiple de minimis thresholds to the same digital assets, the de minimis threshold for PDAP sales applies to digital assets other than qualifying stablecoins. This means, if a customer has PDAP sales of $9,000 using qualifying stablecoins and PDAP sales of $500 using digital assets other than qualifying stablecoins for a calendar year, the PDAP should apply the $600 threshold for the second set of PDAP sales to eliminate the reporting obligation on the PDAP sales of $500. The PDAP would not have to report any of the customer's digital asset transactions for the year.

CARF

It is important to note that the rules for CARF may vary from the rules in the final regulations. CARF requires reporting of acquisitions and transfers of digital assets and for all reporting to take place on an aggregate basis. The CARF has different rules for reporting of stablecoins than the final regulations. Treasury and IRS intend to will publish implementation rules for CARF, where we may see alignment.

Backup withholding

The final regulations provide an exception to the backup withholding rules for brokers utilizing the optional reporting method for sales of qualifying stablecoins and on non-designated sales of qualifying stablecoins. These rules apply to reportable payments occurring on or after January 1, 2025.

Exception for non-designated sales

When identifying a qualifying stablecoin, a broker may use the results-focused test for determining whether it meets the stabilization mechanism requirement for a calendar year. If the broker reports this information on designated qualifying stablecoins under the optional method of reporting, then the broker would not report sales of non-designated qualifying stablecoins.

There may be circumstances where a digital asset loses its peg during a calendar year and therefore does not satisfy the conditions required to be a qualifying stablecoin. Thinking about this holistically, at the beginning of the year, it will be difficult for a broker to know whether a digital asset that would be a qualifying stablecoin for that entire year.

Although Treasury and IRS anticipate that the results-focused test will "rarely" result in a digital asset losing qualifying stablecoin status, there is a significant and possibly permanent loss of parity between the stablecoin and the convertible currency to which it is pegged. If there is a possibility that a qualifying stablecoin loses its peg during a calendar year, a broker will need to be prepared to report and backup withhold on sales of that asset. To give brokers time to learn about such de-pegging events and turn on backup withholding for non-designated sales, the final backup withholding rules provide a grace period before withholding is required. The final regulations provide an exception to backup withholding for sales of digital assets that would have been non-designated sales of a qualifying stablecoin up to and including the date that digital asset loses its peg and no longer satisfies the stabilization mechanism.

Nonqualifying events

The final regulations define the term 'non-qualifying event' as the first date during a calendar year on which the digital asset no longer satisfies all three conditions to be a qualifying stablecoin. For these purposes, the date on which a non-qualifying event has occurred with respect to a digital asset and the date that is no later than 30 days after such non-qualifying event must be determined using UTC.

Under the final rules, a broker is not required to backup withhold on a sale of a digital asset that would have satisfied the definition of a non-designated sale of a qualifying stablecoin for a calendar year but for a non-qualifying event during that year. This is, so long as the sale occurs no later than the end of the day that is 30 days after the first non-qualifying event with respect to such digital asset during such year. For this purpose, a non-qualifying event is defined as the first date during the calendar year on which the digital asset no longer satisfies all three conditions for being a qualifying stablecoin. A broker must determine the amount subject to backup withholding without regard to the de minimis amounts.

De minimis thresholds

Although the final regulations provide *de minimis* thresholds for reporting payment transactions and designated sales of qualifying stablecoins, the transactions that fall below the applicable gross proceeds thresholds may be subject to backup withholding. These amounts are potentially taxable transactions that taxpayers must report on their federal tax returns.

Treasury and IRS have determined that when customers do not provide tax documentation to their brokers, they are less likely to report their digital asset transactions on their federal income tax returns. Customers that provide tax documentation to their brokers are more likely to comply with their own tax reporting. To deter noncompliance, the final regulations impose backup withholding on gross proceeds that fall below the designated thresholds. This means that even though a broker may not have to report gross proceeds due to the application of the $600 threshold for payment transaction sales or the $10,000 threshold for designated sales of qualifying stablecoins, the amounts are still reportable payments for purposes of backup withholding.

KPMG observations

The tailored exemptions for qualifying stablecoins in the final regulations provide relief to brokers; however, there are many details to consider and develop plans for implementing, such as:

- Identifying qualifying stablecoins
  - Determining whether to use the results-based test or the design-focused test
  - Tracking one-to-one pegging
  - Identifying where unpegging may have occurred
- Utilizing the optional reporting method
  - Tracking *de minimis* thresholds
  - Identifying for which customers brokers will use this method
  - Managing consistent reporting methods for each customer during the calendar year
- Backup withholding

- Maintaining and tracking sales and proceeds that are reportable amounts even where *de minimis* thresholds apply or when utilizing the optional reporting method

As brokers begin implementing a process for reporting digital assets, they may need more detailed processes for identifying and tracking which digital assets they are not reporting, such as qualifying stablecoins. Once the process has been defined, the overall benefits from the carveouts and tailored exemptions will outweigh the costs and efforts of implementation.

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