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## Impact of Proposed U.S. Broker Digital Asset Tax Reporting Regulations on Custodial Exchanges

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This article highlights potential impacts of the proposed U.S. broker digital asset tax reporting regulations on exchanges and trading platforms that custody customer digital assets.

Centralized exchanges are generally expected to fall within the purview of the proposed regulations as “brokers” effecting sales of digital assets, either as an agent or as a principal that is a dealer. Thus, while there is a brief discussion of scope below, the article principally focuses on what sales are subject to reporting, what information is reportable and potential exclusions from reporting.

This article is general in nature, and further assessment of the rules against a business’s particular facts will need to be conducted to determine how the rules may apply in the context of that business. Like any proposed regulation, this guidance is subject to change as the U.S. Treasury Department (“Treasury”) and the Internal Revenue Service (“IRS”) work to finalize the regulations. Notwithstanding the potential for changes, taxpayers should begin identifying compliance needs against these proposed rules now, given the relatively short amount of time before the regulations are scheduled to become effective.

### What are the broker crypto reporting regulations?

The 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 otherwise 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 a taxpayer's digital asset sales and to provide taxpayers with tax-relevant information to complete their tax returns for such sales.

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, the type of transactions that are reportable and what is to be reported with respect to digital asset sales.

Under the proposed regulations, reporting on gross proceeds relating to sales of digital assets would be effective for sales occurring on or after January 1, 2025. For certain sales of digital assets that are classified as "covered securities," reporting of cost basis for the sale of such digital assets would be required for sales occurring on or after January 1, 2026.

## **How will this impact custodial exchanges?**

Centralized digital asset trading platforms will generally fall within the scope of the proposed regulations as an agent or principal that is a dealer effecting sales of digital assets for customers. For U.S. digital asset broker, these rules would currently apply to both U.S. and non-U.S. businesses of the broker and to controlled foreign corporations owned by a U.S. broker parent to the extent that the controlled foreign corporation is also a broker.

The broker definition is also broad enough to capture non-U.S. custodial exchanges that are registered as a money services business with the Treasury. There is, however, an exclusion from reporting on a customer of a non-U.S. digital asset broker that is not registered as a money services business if the broker does not have in its account records for the customer certain specified U.S. indicia (e.g., U.S. IP address, U.S. mailing address, indication of U.S. place of birth) or is able to cure the indicia by soliciting additional documentation.

Under the proposed regulations, custodial exchanges treated as brokers would generally be expected to document customers for tax purposes, report on sales of digital assets by U.S. or presumed U.S. customers to both the IRS and the customer and conduct backup withholding on proceeds in some cases (where there is no documentation or invalid documentation for a customer).

Given these requirements, custodial exchanges will need to review their processes or consider new processes for tax onboarding (soliciting tax documentation and validating such documentation), capturing transactional information (e.g., sale date and time, asset sold, wallet address of seller, etc.) and designing and implementing a process for reporting as well as for backup withholding (including, determining when backup withholding would be triggered).

## **For decentralized exchanges, which ones may be required to report?**

We discuss decentralized exchanges in a separate article. Some of those exchanges may be covered in these proposed regulations under a new concept of Digital Asset Middleman and the applicability of these rules to them hinges on whether a person or group of persons retain sufficient control over the platform and its smart contracts.

## What information would a custodial exchange need to report for a digital asset sale?

Reportable digital asset sales can be sales for cash, stored value cards, services, or other property (including other digital assets). For example, a customer’s sale of cryptocurrency for fiat would be a reportable sale. Similarly, a customer selling one cryptocurrency for another cryptocurrency would also give rise to a reportable sale.

For reportable sales, the information to be reported under the proposed regulations extends beyond the data sets that brokers may have for traditional securities.

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. The proposed regulations also provide that the broker should identify what the digital asset was exchanged for (i.e., whether it was exchanged for cash, stored value cards or other property or services). These are data elements particular to digital asset transactions that are not similarly present in traditional financial transactions. In addition, if the digital asset that was sold was transferred into the account/wallet, then information relating to that transfer is also to be reported under the proposed regulations.

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
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)	

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).

## 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, including the following:

**Determining the Amount of Proceeds:** In digital asset to digital asset exchanges, if both assets do not have a fiat tradeable pair, there may be difficulty establishing fair market value for determining proceeds. Even when there are fiat tradeable pairs for the digital assets being exchanged, those fiat prices may not be identical at that particular time (digital asset reporting is based on prices on the particular second the

transaction is executed) and prices may vary across exchanges and marketplaces, such that a reasonable methodology may need to be applied to determine the reportable proceeds amount. From a systems perspective, this may require access to real-time pricing information whether from pricing aggregators or from a list of selected sources. Where a particular cryptocurrency pair is relatively illiquid, there may need to be a separate methodology to accommodate these assets. All this may lead to relatively complex systems.

**Reporting on Digital Assets Transferred into an Account with the Broker:** For sales of digital assets that have been transferred into the customer's account from another source, the proposed regulations require brokers to report information with respect to that prior transfer as part of the sale reporting. For example, if a sale is of 2 ETH and 1.5 Eth from the lot sold was transferred into the account on Date X and .5 ETH was transferred into the account on Date Y, the broker may need to report that the 2 ETH sold comprised of each of those prior transfers, providing the date and time of transfer, the wallet address the transfers came from, etc. In essence, brokers would be required to maintain lot accounting for transfers even though the transferred securities are currently not treated as "covered securities" requiring cost basis reporting.

**Reporting on "Purchases":** In the traditional securities world, a purchase of a security is not a reportable event. However, in the context of digital assets, customers frequently acquire digital assets in exchange for other digital assets. In situations where a customer is "purchasing" one digital asset using another digital asset, the purchase itself is a disposition event with respect to the digital asset used to buy the new digital asset. Systems will need to treat these "purchases" as sales.

**Allocation of Transaction Costs:** Under the proposed regulations, in a digital asset for digital asset exchange (e.g., ETH for BTC exchange), the costs associated with the transaction, including broker fees and gas fees, are allocated 50% to the sold asset (to reduce amount realized) and 50% to the asset acquired (as additional basis). This is different than how broker systems work for sales of securities where costs are all allocated to the sold asset, since for traditional securities sales reporting is only required for sales for cash.

**Tracing Required for Cost Basis Reporting:** The proposed regulations require cost basis reporting with respect to the sale of digital assets that are "covered securities." This will include digital assets acquired on or after January 1, 2023, in a broker hosted wallet and maintained in such account until the date of sale. This will require brokers to trace back acquisition information to January 1, 2023, prior to the date the proposed regulations were even issued. Brokers will need to review their systems to review systems to ensure they capture cost basis information from January 1, 2023, onwards and accelerates the need to modify systems as necessary to capture information that may be required for cost basis reporting.

**Coordination with Derivatives Reporting:** The reporting of derivatives on digital assets adds to the complexity that already exists with respect to the reporting of forwards, options, and futures contracts. Under the proposed regulations, derivatives that are not themselves digital assets are generally reported under existing rules. If the derivatives are digital assets, however, then they are reported under the digital asset sales framework. This may require a review of derivative products that are being traded on the platform to properly assign correct reporting procedures for the product.

**Coordination with Reporting on Securities Sales:** If a broker facilitates both digital asset trading and trading in traditional securities, systems will need to be able to identify securities that may be digital assets and coordinate reporting. Certain digital assets that are also securities (e.g., tokenized shares of stock) would be reported under the digital asset framework under the proposed regulations. Broker systems will need to identify digital asset securities vs non-digital asset securities.

## Who does a custodial exchange need to report to? Are there exclusions to reporting?

Generally, the proposed broker reporting regulations require reporting to customers that are U.S. persons. Certain U.S. persons that the IRS deems 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 custodial exchange can document a customer as a non-U.S. person, reporting to that customer is generally not required for purposes of these regulations. For U.S. digital asset businesses, a Form W-9 should generally be requested from U.S. persons and a Form W-8 from a non-U.S. customer. There are situations such as for a digital asset broker 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 or drivers’ licenses) to substantiate non-U.S. status.

There is also an exclusion from reporting, as noted above, for certain non-U.S. exchanges (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 there is no documentation that has been provided by a user or the documentation provided is invalid or has expired, there are presumption rules that would allow a broker 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 custodial exchange should be concerned with?

One of the challenges with complying with the information reporting framework set forth in the proposed regulations is the lack of guidance on the taxation of many common place digital asset transactions (e.g., digital asset loans, forks, staking, wrapped tokens, etc.). The proposed regulations do not provide guidance on these issues. Presumably, other information reporting rules (e.g., for miscellaneous income) could apply in some cases, but reporting may also depend on how the substantive tax rules are decided upon. Thus, brokers may need to take positions with respect to the tax implications of digital asset-related events that may not be clear as a matter of law.

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.

In addition, the current proposed regulations do not provide guidance with respect to broker reporting on transfers of digital assets from one broker to another broker or from a broker account to a non-broker wallet. Guidance on these rules is expected in the future and may impact the scope of cost basis reporting, but also may require systems builds to accommodate.

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, broker 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 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 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.

Backup withholding systems can be complicated to implement, and issues arise on a digital asset trading platform where the proceeds are in the form of another digital asset. If it is determined that such digital asset received would need to be liquidated to pay backup withholding taxes, a host of additional issues may arise, from feasibility of such liquidations to the fact that such liquidation may give rise to another sale that is also reportable.

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

There are numerous actions that custodial exchanges 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. Of particular interest may be the understanding of any demarcation between U.S. and non-U.S. businesses.
- 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.
- Begin considering business requirements in terms of enhancing current systems for digital asset tax reporting:
  - Do systems capture information required for reporting? For example, certain digital assets acquired in hosted accounts as of 1/1/23 could require cost basis reporting for sales occurring on or after 1/1/2026 (*i.e.*, the proposed regulations would essentially require retroactive reporting).
  - 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.

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