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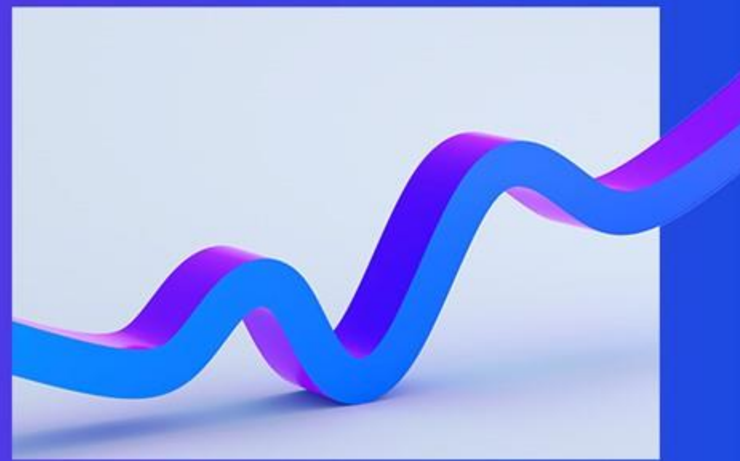

Impact of Proposed U.S. Broker Digital Asset Tax Reporting Regulations on NFT Marketplaces

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> This article highlights potential impacts of the proposed U.S. broker digital asset tax reporting regulations on NFT marketplaces.
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> NFT marketplaces operate under different models, and the impact of these rules will vary depending on the business model utilized by the marketplace, the types of tokens that exist on the platform, and what users may be allowed to do on it. Thus, for example, an NFT marketplace that provides custody of NFT assets will likely be impacted differently than one that operates on a self-custody model. And hybrid marketplaces that offer users both custodial and non-custodial options or that also allow users not only custody of NFTs but also cryptocurrencies may see impacts different in degree and kind.

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.

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 NFT marketplaces?

Each NFT marketplace has its own operational structure and thus will be impacted differently by these regulations. For example, whether a marketplace is custodial or non-custodial or a hybrid will matter in the analysis, as will the type of transactions allowed on the platform (*e.g.,* convertible virtual currency for NFT, fiat for NFT, or NFT for NFT swaps). For non-custodial platforms, the regulations may or may not treat such platforms as reporting brokers, depending on the degree of control retained by the person or persons operating the marketplace.

For those marketplaces treated as brokers effecting sales of digital assets under these regulations, the marketplace 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 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 marketplace falls within the reporting framework set out by the proposed regulations, the platform 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 customer. In-scope entities will also need to design and implement a process to backup withhold on proceeds of sales.

For decentralized marketplaces, which ones may be required to report?

Decentralized marketplaces are usually ones where users connect their un-hosted (self-custody) wallets to the platform to interact with buyers and sellers doing the same through the use of the platform's smart contracts. As described below, whether decentralized marketplaces are within the scope of the reporting rules will depend on whether there is a person or persons who retain sufficient control over the platform and its smart contracts.

The proposed regulations introduce the concept of a Digital Asset Middleman. A Digital Asset Middleman is any person who provides a service that directly or indirectly effectuates a sale of digital assets (a facilitative service), including providing a party in the sale with access to an automatically executing contract or protocol, if the nature of the service arrangement is such that the person ordinarily would know or be in a position to know (a) the identity of the party that makes the sale and (b) the nature of the transaction potentially giving rise to gross proceeds from the sale. If a platform is acting as a Digital Asset Middleman with respect to a sale of digital assets, it would generally be required to report the sale.

Under the proposed regulations, a person ordinarily would know or be in a position to know the identity of the party that makes the sale if that person maintains sufficient control or influence over the facilitative services provided to “have the ability to set or change the terms under which its services are provided to request the party making the sale provide that party’s name, address, and taxpayer identification number upon request.” That is, if the marketplace has the ability amend its contracts or user interface to request such information, then it would be treated as having sufficient control even though it currently does not request such information.

A person would know or be in a position to know the nature of the transaction as potentially giving rise to gross proceeds (i.e., that it is a sale or exchange) if that person, again, retains sufficient control or influence to determine whether and to what extent transfers of digital assets in a transaction gives rise to gross proceeds, including by reference to fees the person receives from the sale.

In both the above cases, the ability to change the fee charged by the marketplace on a sale is set forth as an example where a person has sufficient control or influence over the facilitative service in order to be treated as Digital Asset Middleman.

Thus, for decentralized exchanges, whether the proposed regulations will be applicable will involve reviewing somewhat granular workings of the smart contracts and what amendments may be made. For certain decentralized platforms that are not operated by a single person or entity, there will also likely be questions as to the appropriate reporting person if such control or influence exists within a group of otherwise unaffiliated persons.

What information would NFT marketplaces need to report?

Reportable digital asset sales can be sales for cash, stored value cards, services, or other property (including other digital assets). For reportable sales, the information to be reported under the proposed regulations extends beyond the data sets that brokers may have for traditional securities.

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)	

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. These are data elements particular to digital asset transactions that we do not see in the traditional financial services area. In addition, if the digital asset was transferred into the account/wallet, 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).

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:

Reporting to Both Parties to an Exchange: If an NFT is purchased not using fiat but with cryptocurrency (*e.g.*, ETH or MATIC or TEZ), the exchange gives rise to at least two reportable transactions. The buyer paying with cryptocurrency would be treated as selling that cryptocurrency, and the seller would be treated also as selling a digital asset (the NFT itself). Thus, reporting is not only to sellers in a marketplace but also to buyers in these scenarios. This dual reporting is different than what exists for brokers with respect to sales of securities or for marketplace payment processors that currently report sales proceeds of marketplace sales to sellers only.

NFT for NFT Exchanges: Perhaps one of the more problematic issues is where a platform allows a user to swap with another user one NFT for another NFT. In such case, it may not be possible to determine the value of the NFTs being exchanged and gross proceeds may be undeterminable. The proposed regulations allow for a case where the broker could report undeterminable proceeds. The question for NFT marketplaces may be whether all NFT for NFT exchanges would fall into this category and whether some level of diligence may be expected before making this determination.

Allocation of Transaction Costs: Under the proposed regulations, in a digital asset for digital asset exchange (e.g., convertible virtual currency for NFT or NFT for NFT), 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. This is not so with sales of digital assets.

Cryptocurrency Conversions: If a marketplace allows a user to convert one digital asset to another (e.g., ETH to MATIC) so that the user can purchase NFTs on the marketplace that are on different blockchains or effect a bid or offer on an NFT, the conversion transactions may need to be captured as sales as well. In some platforms, users may need to convert ETH to Wrapped Ether and vice versa to make bids on NFTs. In such case, more guidance will need to be provided by the IRS and Treasury as to whether transactions such as these are treated as sales for tax reporting purposes.

Hosting of Cryptocurrency: A similar issue reporting issue arises if the platform provides custody of digital assets such as convertible virtual currencies and allows for withdrawal in fiat to bank accounts. These withdrawals may also be captured as sales, and if a third-party off-ramp provider is assisting in this process, the functions of the marketplace relative to the third-party off-ramp provider may need to be analyzed to determine proper reporting. There is no multiple broker exception for reporting on digital assets under the proposed regulations so in certain cases reporting responsibility could theoretically fall to two or more parties, resulting in duplicative reporting.

NFT Minting and Drops: The proposed regulations exclude an NFT minter from the scope of a reporting broker. Thus, an individual for example who creates and mints the NFT generally would not be required to report. But if the marketplace assists the minter in selling the NFT, presumably that is a reportable sale. Questions arise where the platform itself is minting NFTs and is also facilitating NFT drops for others. In such case, there may be a difference in treatment between the platform's own NFTs and those where it acts as an agent for the drop. There may also be grey areas where an NFT collection is jointly sponsored by the platform and an outside third-party (brand owner). These issues will need to be addressed for those platforms that are selling their own NFTs or issuing their own tokens.

Royalties on Secondary: In NFT secondary sales, where a "royalty" fee may be paid to the original creator, it is not entirely clear whether that fee should be treated as additional gross proceeds to the creator or other income that is reportable. If these payments represent additional proceeds, systems may need to be designed to report on the sale with respect to the buyer, seller and NFT creator. This could require three levels of reporting for a single transaction.

To whom does an NFT marketplace need to report? Are there exclusions from reporting?

Generally, the proposed broker reporting regulations require reporting to customers 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 an NFT marketplace 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 broker/marketplace 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.

There is also an exclusion from reporting for certain non-U.S. marketplaces (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 marketplace/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 an NFT marketplace should be concerned with?

One of the other challenges with information reporting given the proposed regulations beyond those discussed above is that these regulations govern principally sales or exchanges of digital assets reporting to U.S. persons. They do not provide guidance over reporting of other income events. What is to be reported, for example, where in a custodial marketplace an NFT creator airdrops a new NFT to all holders in a collection? Presumably, other information reporting rules (*e.g.,* for miscellaneous income) would apply. Similarly, if there is a royalty fee paid to creator on a secondary sale and it is not treated as additional proceeds, the marketplace may still need to report under other Form 1099 frameworks. And part of the difficulty in complying with tax information reporting rules will be the need to look not only at the proposed broker reporting regulations but also at other applicable reporting regimes.

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 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 in the NFT marketplace world where proceeds are in the form of an NFT or another digital asset. It is not clear whether the IRS will require liquidation of NFTs in this circumstance to pay the backup withholding tax and whether this can practicably be done in the context of decentralized marketplaces or even centralized marketplaces since an NFT is not divisible in the manner of a fungible payment token and the digital asset received may be illiquid. In effect, the impracticality of backup withholding in digital asset for digital asset exchanges may require a marketplace to prevent this population of persons subject to backup withholding from participating in these transactions altogether. Withholding on proceeds would essentially convert a purchase of an NFT using digital assets into a sale of the digital asset used as a payment medium if the NFT received in the exchange must be liquidated in order to pay backup withholding tax.

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

There are numerous actions that NFT marketplaces 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 custodial or other NFT marketplaces that likely will fall into the reporting category, more assessment as readiness of systems and processes:
  - 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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