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Handicapping the IRS Broker Rule

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PolicyPartner believes the IRS will finalize the proposed "broker rule" before June 2024. The proposed regulation would implement provisions in the Infrastructure Investment and Jobs Act (IIJA) to require digital asset brokers to collect information and issue 1099s on digital asset transactions.

In this note, we share a filtered database of legitimate comments submitted to the IRS (corporate/association only) and review takeaways from open hearing the IRS hosted on the rule earlier this year (the transcript can be found here.)

While the rule as proposed would have a significant negative impact on the digital asset industry in the US, we believe the IRS will likely make changes to the rule to make implementation and compliance more realistic.

We were able to filter out comments from individuals and anonymous – a herculean feat given over 44,000 comments were submitted. Please find the spreadsheet of these comments linked to here. In comment letters and in the public hearing, the digital asset industry raised serious concerns that will likely impact the final rule. We point out however, that the proposed rule has support from left leaning tax institutions and politically powerful trade groups outside of crypto.

Left-leaning voices in support of the rule:

- Independent Community Bankers of America (ICBA)
- Tax Law Center at NYU Law
- Americans for Financial Reform/Demand Progress

Independent voices resisting the rule:

- American Escrow Association
- Fidelity Investments
- Electronic Transactions Association
- CBOE
- New York State Bar Association Tax Section
- New York State Bar Association Task Force on Emerging Digital Finance and Currency

Speculation on changes:

- The IRS could narrow the interpretation of "broker" to only centralized exchanges and those that effectuate a transaction – more similar to a VASP as outlined by FATF,
- exempt stablecoin transactions and other nonfinancial transactions,
- revise rules for tokenized real estate,
- create a reasonable de-minimis reporting threshold,
- narrow the interpretation of "effectuate,"
- or extend the implementation date.

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Public hearing offers insights into IRS interest in amendments
The IRS panelists focused follow up questions on exemption for nonfinancial transactions and transactions that resulted in no gain or loss. The IRS also seemed interested in the industry's plea for relief on these issues – the moderators also asked for a proposed definition of a stablecoin and if brokers could feasibly review NFT transactions to see which are financial in nature.

There were also several follow up questions on how the **definition of broker in the rule was inconsistent with FATF guidance on VASPs**. Updated FATF guidance on Defi can be found here – key to determining if something is a VASP: holding the keys, persons involved in governance structures, concentration of influence and ability to amend, ability to affect the defi protocol, and profit/fee structures.

Key industry amendment request/complaints

- Definition of "Intermediary" has been misinterpreted – indirect influence the transfer of digital assets does not constitute intermediation of digital assets. This interpretation of these broad categories "stretches the meaning of the statue beyond the breaking point."
    - Providing an automated market maker system
    - Providing services to find the best price
    - Providing noncustodial wallet services that allow platform access
    - Providing services that allow access to the internet
- The rule pulls in any person providing a facilitative service who is in a position to know the ID of a party that makes the sale, even if indirectly.
- The legislative text was intended to cover digital asset brokers, not "any and all persons who facilitate and participate in the digital asset economy".
- The rule would prevent the use of decentralized financial technology, which has many benefits
- The rule would capture nonfinancial transactions
- The rule would capture transactions that do not result in a material gain or loss
- The rule would create erroneous reporting in tokenized real-estate and tokenized mutual fund tax reporting.
- Cost basis is difficult for an intermediary to determine on transactions involving tokenized interests in LLCs or partnerships
- Requests to exclude NFTs that are not financial instruments
- NFTs have value, but are not representations of value, congress viewed digital asset to mean a type of financial instrument, NFTs are not this.
- Given the overly broad definitions, many participants in the chain of an NFT transactions will report the same data via 1099-DA
- Reporting requirements will create the risk PII is improperly disclosed.
- Self-reporting using P/L generated using blockchain records, similar to a 6050W, is more appropriate.
- The rule will cause custodial brokers to report incorrect information – the IRS will have to process this data, and it will waste time.

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- Noncustodial brokers don't see cost basis information.
- The IRS should allow the use of transaction aggregators to calculate cost basis
- The APA requires a rule to substantial evidence to quantify the costs or benefits as required by the APA – the costs are underestimated and the additional burden on Treasury is not included. Benefits to the tax gap are not included.
- Requiring software developers to compel users to disclose information is compelled speech – a violation of the First Amendment.

Timing
The IRS has marked the second quarter as the date of a final rule. Depending on the number of legislative days, a CRA challenge cannot be brought if the rule is finalized before a certain date (typically this is May-June). We believe the IRS is serious about implementing this rule so we do think they will try to finalize before the CRA date, but within the proposed timeframe. Hence, we believe the IRS will finalize the rule before June of this year.

Further, congressional protest has recently emerged (see the letter sent to the IRS by the Ways and Means Committee). The legislative branch can have excellent intel on administrative rulemaking activity. Letters like this one indicate this group has heard the rule is moving and they are concerned / want to bring attention to the problem to create political pressure. This letter is somewhat significant as this committee was the principal actor on the tax provisions in the IIJA. Richard Neil was the chairman of the committee as the time of IIJA passing, and he and other key democrats are not on this letter.