Final regulations require DeFi brokers to file information returns and furnish payee statements

February 11, 2025

In brief

What happened?

Treasury and the IRS on December 27 issued final regulations (Final Regulations) classifying certain decentralized finance (DeFi) participants (DeFi participants) that provide trading front-end services effectuating digital asset sales and exchanges as "brokers" (DeFi brokers). DeFi brokers are required to file and furnish Form 1099-DA, *Digital Asset Proceeds From Broker Transactions,* reporting the gross proceeds on dispositions of digital assets. The Final Regulations apply to sales of digital assets effected by DeFi brokers that occur on and after January 1, 2027. DeFi brokers must file and furnish the first Forms 1099-DA in January 2028.

The IRS concurrently issued Notice 2025-3, which provides transitional relief from penalties for DeFi brokers who fail to file required information returns and furnish required payee statements in 2028 for sales of digital assets effected in calendar year 2027, provided that the DeFi broker makes a good faith effort to comply with the filing obligations. The notice also provides transitional relief from the liability for the payment of backup withholding tax as well as from penalties for DeFi brokers who fail to pay that tax with respect to certain sales of digital assets.

The IRS on December 31 issued Notice 2025-7 providing temporary relief allowing eligible taxpayers to use certain alternative methods for making an adequate identification of units of digital assets held in the custody of a broker that are sold, disposed of, or transferred during calendar year 2025. Taxpayers must treat the earliest acquired digital asset units held in the custody of a broker as the units sold, disposed of, or transferred unless the taxpayer provides the broker with adequate identification of the units sold, disposed of, or transferred.

Why is it relevant?

Treasury and the IRS on June 28, 2024 released final regulations (June 2024 Regulations) requiring Form 1099-DA to be filed by certain digital asset service providers (custodial trading platforms, hosted wallets, etc.). The June

2024 Regulations reserved for further consideration the obligation that may apply to DeFi participants. The Final Regulations impose information reporting and backup withholding obligations on DeFi brokers. These brokers will have two years to prepare for the reporting obligation.

Action to consider

The Final Regulations require DeFi brokers to take steps to modify their operations to enable them to comply with the information reporting and backup withholding associated with effecting digital asset sales made by US non-exempt payees (individuals, partnerships (including LLCs treated as partnerships), trusts, estates, and S-corps). DeFi brokers should review and update as necessary their current terms of service or other relevant contractual agreements with customers to address the US tax information reporting and backup withholding obligations. Existing customer onboarding processes should be modified to require the collection of US withholding certificates (Forms W-8 and W-9). DeFi brokers' data collection and retention associated with transactions they facilitate should be reviewed and modified to ensure the data required by Form 1099-DA is available to be reported for transactions that occur on or after January 1, 2027.

In detail

Background

August 2023 Regulations

Treasury and the IRS on August 25, 2023 issued proposed regulations (August 2023 Regulations) relating to information reporting by brokers that generally act as agents and dealers in transactions with their customers involving digital assets.

The August 2023 Regulations included rules that would apply to brokers that act as digital asset middlemen (i.e., persons who provide a facilitative service related to the sale of a digital asset). These regulations also provided that a facilitative service would include any service that directly or indirectly effectuates a sale of a digital asset if the service provider is in a position to know the identity of the party making the sale and the nature of the transaction. This proposed new category of broker would include certain participants that operate within the DeFi segment of the digital assets industry.

The DeFi ecosystem offers services that allow for financial transactions that use automatically executing software commonly referred to as smart contracts based on distributed ledger technology without any DeFi participant taking custody of the private keys used for accessing the digital asset customer's digital assets on a distributed ledger.

See our Insight, *Treasury issues extensive proposed regulations with broad scope around digital asset information reporting*, for more information on the August 2023 Regulations.

June 2024 Regulations

The June 2024 Regulations require certain custodial brokers that take possession of the digital assets being sold or exchanged by their customers.to file information returns and furnish payee statements reporting gross proceeds and in certain circumstances adjusted basis on sales of digital assets effected for customers beginning for sales on or after January 1, 2025.

The June 2024 Regulations generally apply to digital asset brokers that act as agents for a party in the transaction, such as operators of custodial digital asset trading platforms, certain digital asset hosted wallet providers, and

certain processors of digital asset payments (PDAPs), as well as persons that interact with their customers as counterparties to transactions, such as owners of digital asset kiosks, brokers who accept digital assets as payment for commissions and certain other property, brokers that transact as dealers in digital assets, and certain issuers of digital assets who regularly offer to redeem those digital assets.

The June 2024 Regulations did not finalize the definition of digital asset middleman from the August 2023 Regulations as applied to DeFi participants (referred to in the preamble to the June 2024 Regulations as non-custodial industry participants) because Treasury and the IRS determined that additional consideration of the issues and comments received with respect to these participants was warranted. Instead, the June 2024 Regulations reserved on the proposed definition of digital asset middleman that would have treated these participants as brokers.

The preamble to the June 2024 Regulations also indicated that Treasury and the IRS intended to expeditiously issue separate final regulations with respect to these participants.

See our Insight, *Treasury finalizes framework for digital asset information reporting; reserves key areas for future study*, for more information on the June 2024 regulations.

Final Regulations

The Final Regulations adopt the August 2023 regulations' definition of digital asset middleman, but (1) narrow the scope of DeFi participants that meet the definition of a digital asset middleman, (2) change the term facilitative services used in the proposed definition of digital asset middleman to the term effectuating services, and (3) apply the definition only to DeFi participants that provide trading front-end services that enable customers to interact with DeFi trading applications. Thus, DeFi participants who regularly provide trading front-end services effectuating certain digital asset sales and exchanges are treated as brokers subject to the information reporting requirements when the nature of the service arrangement is such that the broker providing that service ordinarily would know, or be in a position to know, the nature of the transaction potentially giving rise to gross proceeds from the sale or exchange of digital assets.

A DeFi broker providing trading front-end services "ordinarily would know or be in a position to know" the nature of the transaction potentially giving rise to gross proceeds from a sale of digital assets if that broker maintains control or sufficient influence over the trading front-end services to have the ability to determine whether and the extent to which the transfer of digital assets involved in a transaction gives rise to gross proceeds.

The Final Regulations provide that a person would meet this control or sufficient influence standard if that person has the ability to:

- amend, update, or otherwise substantively affect the terms under which the services are provided or the manner in which the order is processed;
- collect the fees charged for the trading front-end services from the transaction flow (that is, from the digital assets disposed or the digital assets received in the trade order); and
- add to the order a sequence of instructions to query the distributed ledger to determine if the processed order is, in fact, executed or to use another method of confirmation based on information known to that person as a result of providing the trading front-end services.

These DeFi brokers must file information returns on Form 1099-DA and furnish payee statements reporting gross proceeds on sales of digital assets effected for customers beginning for sales of digital assets effected on or after January 1, 2027.

Observation: The deferred effective date provides welcome relief given the difficulty of implementing these concepts in specific DeFi protocols. The determination of activities and protocols that may be in scope is complex. Impacted taxpayers should consider beginning such analysis now, regardless of the deferred effective date.

Notice 2025-3

To provide DeFi brokers with more time to develop appropriate procedures to comply with these new information reporting obligations, Notice 2025-3 provides certain relief from penalties for (1) for any sale of a digital asset effected by a DeFi broker during calendar year 2027and (2) for any sale of a digital asset effected by a DeFi broker during calendar year 2028 for a customer payee if the broker submits that payee's name and tax identification number (TIN) combination to the IRS's TIN matching program and receives a response that the name and TIN combination furnished by the payee matches the name and TIN combination for that payee in IRS records.

Observation: Use of the IRS TIN Matching Program generally can be used as part of a reasonable cause abatement request for penalties related to filing incorrect payee name and TIN combinations. DeFi brokers that utilize this process during the transition period should continue its use as part of their information reporting and withholding policies, procedures, and controls.

For sales effected before January 1, 2029, Notice 2025-3 also provides that a DeFi broker may treat a customer as an exempt foreign person if the customer previously has not been classified as a US person by the DeFi broker, and the information that the DeFi broker has for the customer includes a residence address that is not a US address.

In addition, Notice 2025-3 provides transitional relief from penalties for DeFi brokers who fail to impose backup withholding and pay the full backup withholding tax due if such failure is due to a decrease in the value of withheld digital assets in a sale of digital assets in return for different digital assets effected on or before December 31, 2028, and the broker immediately liquidates the withheld digital assets for cash.

In addition to the relief provided by Notice 2025-3, DeFi brokers also are eligible for relief provided in Notice 2024-56, which applies to digital asset sales effected by a DeFi broker under the Final Regulations where the reportable proceeds are a specified non-fungible token. Additionally, the backup withholding relief provided in Notice 2024-56 for PDAP sales effected by a PDAP also will be applicable to PDAP sales effected by a DeFi broker that is also a PDAP.

Observation: Like other brokers obligated to report gross proceeds, DeFi brokers will be obligated to collect reliable Forms W-9 and W-8 to properly document their users and avoid the obligation to impose backup withholding. The relief provided by Notice 2025-3 requires DeFi brokers at a minimum to collect their US users' TINs in any manner prior to January 1, 2027, and to identify users with only a non-US address. This provides DeFi brokers with extra time to develop appropriate methods to collect reliable withholding certificates and avoid the obligation to impose backup withholding.

Notice 2025-7

The IRS on December 31 issued Notice 2025-7 providing temporary relief allowing eligible taxpayers to use certain alternative methods for making an adequate identification of units of digital assets held in the custody of a broker that are sold, disposed of, or transferred during calendar year 2025.

The June 2024 Regulations provide ordering rules for determining which units of the same digital asset should be treated as sold, disposed of, or transferred when a taxpayer holds multiple units of that same digital asset within the same wallet that were acquired on different dates and at different prices. For digital assets held in the custody of a taxpayer's broker, the June 2024 Regulations generally permit a taxpayer to make an adequate identification of the

units to be sold, disposed of, or transferred by specifying to the custodial broker, no later than the date and time of the sale, disposition, or transfer, the particular units to be sold, disposed of, or transferred by reference to any identifier that the broker designates as sufficiently specific to allow it to determine the basis and holding period of those units.

The June 2024 Regulations also permit taxpayers to make an adequate identification of such units by using a standing order or instruction communication to their custodial broker. Further, if the custodial broker offers taxpayers only one method of making a specific identification, the June 2024 Regulations treat such method as a standing order or instruction.

For units held in the custody of a broker but for which the taxpayer does not make an adequate identification of the units sold, disposed of, or transferred, the June 2024 Regulations treat such units as sold, disposed of, or transferred in order of time from the earliest date on which units of that same digital asset held in the custody of a broker were acquired by the taxpayer (FIFO rule). Regardless of whether the taxpayer makes an adequate identification, in the case of digital assets exchanged for different digital assets, the June 2024 Regulations treat any units withheld for the broker's backup withholding obligations or for payment of services as coming from the units received in the exchange.

Contemporaneously with the issuance of the June 2024 Regulations, the IRS issued Rev. Proc. 2024-28 providing guidance to taxpayers regarding how to transition from a universal or multi-wallet basis allocation methodology to a wallet-by-wallet or account-by-account basis allocation methodology. Specifically, subject to certain requirements, Rev. Proc. 2024-28 provides a safe harbor on which taxpayers may rely to allocate their units of unattached basis to a digital asset wallet or account that holds the same number of remaining digital asset units based on the taxpayer's records of such unattached basis and remaining units so long as the allocation is reasonable. Rev. Proc. 2024-28 permits taxpayers either to make a specific unit allocation or to make a global allocation in order to allocate units of unattached basis, subject to various conditions.

Notice 2025-7 notes that digital asset brokers may not have in place by January 1, 2025 the technology needed to accept specific instructions or standing orders communicated by taxpayers. These technological limitations may leave some taxpayers unable to make adequate identifications. Thus, by default, any units in the custody of such brokers that are sold, disposed of, or transferred would be determined under the FIFO rule.

Accordingly, Notice 2025-7 provides temporary relief allowing taxpayers to use additional methods for making an adequate identification during calendar year 2025. A taxpayer may make an adequate identification of its units held in the custody of a broker by:

- Identifying, no later than the date and time of the sale, disposition, or transfer, on the taxpayer's books and records, the particular units to be sold, disposed of, or transferred by reference to any identifier, such as purchase date and time or the purchase price for the unit, that is sufficient to identify the basis and holding period of the units sold, disposed of, or transferred; or
- Recording a standing order on the taxpayer's books and records, provided that the recorded standing order includes sufficient information to identify any digital asset units sold, disposed of, or transferred and is entered into the taxpayer's books and records before the units covered by the order are sold, disposed of, or transferred.

If a taxpayer makes an adequate identification under one of these two options, the rule in the June 2024 Regulations treating taxpayers whose broker offers only one method of making a specific identification as having made a standing order or instruction, does not apply during calendar year 2025.

Taxpayers relying on the safe harbor under Rev. Proc. 2024-28 may rely on the temporary relief provided by Notice 2025-7 only after all six of the applicable requirements of Rev. Proc. 2024-28 have been satisfied.

***Observation**:* The notice provides welcome relief to both taxpayers and industry participants in providing brokers more time to update their systems to accommodate specific lot relief methodologies. Impacted taxpayers should assess their books and records identification process (including any standing orders) to determine compliance with this notice.

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Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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