Via Electronic Submission and Mail

November 11, 2023

Internal Revenue Service
CC:PA:LPD:PR (REG 122793-19)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Gross Proceeds and Basis Reporting by Brokers and Determination of Amount Realized and Basis for Digital Asset Transactions

Dear Sir or Madam:

Proof of Stake Alliance ("**POSA**" or "**we**")[1] appreciates the opportunity to comment on the proposal by the U.S. Department of Treasury (the "**Treasury Department**") and Internal Revenue Service (the "**IRS**") to extend the information reporting rules in Internal Revenue Code ("**IRC**") § 1.6045-1 to persons, who, for consideration, are responsible for regularly providing services effectuating transfers of digital assets on behalf of another person in accordance with the Infrastructure Investment and Jobs Act of 2021, P.L. 117-58 (the "**Act**"). POSA respectfully submits that the proposed regulations on gross proceeds and basis reporting for digital asset transactions (the "**Proposed Rule**"),[2] if adopted, would discourage innovation in proof-of-stake validation technology because the regulations would not unambiguously exclude validation services from the scope of the "broker" definition.

As further discussed below, Congress intended to exclude providers of validation services and software from regulation as "brokers." While POSA commends the Treasury Department and IRS for acknowledging this intent and including an exclusion from the definition of "facilitative services" for "validating distributed ledger transactions" on proof-of-stake blockchain networks, the exclusion provides that such validation services and software cannot include "other functions or services." This vague qualifying language leaves open the possibility that many validation services and software providers,

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1 POSA is a nonprofit industry alliance whose members include the leading enterprises that advance or service existing protocols that are built on proof-of-stake technology. POSA's goal is to foster increased adoption of proof-of-stake blockchain networks in the United States.

2 *Gross Proceed and Basis Reporting by Brokers and Determination of Amount Realized and Basis for Digital Asset Transactions*, 88 Fed. Reg. 59576 (Aug. 29, 2023) ("Proposing Release").

including staking-as-a-service providers ("**StaaS Providers**") and liquid staking software providers ("**LS Providers**"), may be deemed "brokers" by virtue of providing functions and services integral to the validation service or software, such as a graphical user interface (or "front-end"), slashing coverage or cryptographic receipt token. POSA submits that any application of the information reporting rules to such validation services and software providers would contravene Congressional intent and the text of the Act. Additionally, such application of the information reporting requirements would place the security of proof-of-stake blockchains and digital asset users' transactions at significant risk.

POSA respectfully urges the Treasury Department and IRS to remove the "other functions or services" language or amend the language to clarify that it is intended to cover "other functions or services *that are not integral to the provision of validating services or software*." Finally, in the event that the Treasury Department and IRS intend to subject StaaS Providers and LS Providers to the Proposed Rule, POSA requests that the Treasury Department and IRS delay the effective date by at least two years.

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I. Congressional Intent, Statutory Text and Historical IRS Positions Support Exclusion of StaaS Providers and LS Providers

POSA commends the Treasury Department and IRS for including in the Proposed Rule an exclusion from the definition of "facilitative services" for "validating distributed ledger transactions." However, POSA submits that proposed exclusion, as currently worded, would contravene Congressional intent by limiting application of the exclusion to persons who do not provide "other functions or services."

Congress intended for the Act to extend information reporting requirements to persons who sell digital assets on behalf of customers. To achieve this end, the Act broadened the definition of "broker" under IRC § 6045 to include persons who "*effectuate* transfers of digital assets on behalf of another person." The Joint Committee of Taxation described the Act's revision of the "broker" definition as a change that "clarifies existing law."[3] The Act solely modified the definition of "broker" as needed to clarify that the existing IRC § 6045 applies to sales of digital assets in the same manner as sales of other types of assets within scope of the information reporting requirements.

Validator services and software providers, such as StaaS Providers and LS Providers, are not currently subject to the information reporting requirements because such persons solely perform technical services and/or publish software code. These persons do not transact in or custody digital assets on behalf of third parties. Congress did not intend to expand the concept of a "broker" to include such persons.

This intent is evidenced by a colloquy made by Senators Rob Portman and Mark Warner on August 9, 2021 in regards to the Act.[4] On the Senate Floor, the Senators explained that the Act "*makes it clear* as to who counts as a broker within this matter. . . 'any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.' For tax purposes, *this means a sale on behalf of someone else* . . . ."[5] The Senators confirmed that the "purpose of this provision *is not to impose new reporting requirements on people who do not meet the definition of brokers*."[6] The Senators also directly addressed the question of whether validation services and software

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[3] Congressional Record 167: daily ed. August 3, 2021, p. S5702.

[4] Legislative Session, Congressional Record Vol. 167, No. 144, Page S6069 (emphasis added).

[5] *Id.* (emphasis added).

[6] *Id.* (emphasis added).

providers are intended to be within scope of the Act, stating that a person who is "solely involved with validating distributed ledger transactions through proof of work . . . will not be considered a broker. *The same would be true for proof of stake validation and other validation methods now or in the future associated with other consensus mechanisms that are developed and might come into the market as the technology evolves*"[7] The Treasury Department acknowledged this intent in a February 11, 2022 letter confirming that it would promulgate regulations under the Act that would "be based on principles broadly similar to those applicable under current law for broker reporting on securities transactions."[8]

Notwithstanding the unambiguous intent of Congress, the Proposed Rule would not clearly exclude validation services from the scope of the "broker" definition. Although the Act solely expanded the definition of "broker" to cover persons who "effectuate transfers of digital assets on behalf of another person," Proposed Rule § 1.6045-1(a)(10) would include within the definition a broad swath of persons who act as a "digital asset middleman . . . for a party in a sale of digital assets."[9] Proposed Rule § 1.6045-1(a)(21), in turn, defines a "digital asset middleman" as any person who provides a "facilitative service" with respect to a sale of digital assets. The term "facilitative service" is broadly defined to include any "service that directly or indirectly effectuates a sale of digital assets," but expressly states that the term "does not include validating distributed ledger transactions (whether through proof-of-work, proof-of-stake, or any other similar consensus mechanism) *without providing other functions or services if provided by a person solely engaged in the business of providing such validating services*."

The proposed exception to the exclusion for validation services would swallow the rule. Neither the text of the Proposed Rule nor the discussion of the same in the Proposing Release make clear what would constitute an "other function or service." As a result, the Treasury Department and IRS could deem to be a "broker" any provider of validation services or software that provides related functions and services, such a front-end, slashing coverage or cryptographic receipt tokens, among other innovative embedded services and features. In contravention of the Act's statutory text and Congressional intent, the Treasury Department and IRS offer an exclusion for validation services and software providers that would seemingly apply to few if any persons actually offering such services and software.

Moreover, the Act defines a "broker" as a person who "effectuates" transfers of digital assets. Congress believed that its inclusion of the term "effectuate" made it "clear" that the term "broker" excluded persons that provide validation services and did not intend for the Treasury Department or IRS to bring such persons within scope of the definition through regulation. The term "effectuate" is not defined in the Act and so the Treasury Department and IRS must consider its ordinary meaning.[10] Merriam-Webster Dictionary defines the term "effectuate" to mean "to cause or bring about (something) : to put (something)

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7 *Id.* (emphasis added).

8 Letter from Jonathan C. Davidson, Assistant Secretary for Legislative Affairs, U.S. Treasury Department, to Senators Portman, Warner, Crapo, Sinema, Toomey and Lummis.

9 Proposed Rule § 1.6045-1(a)(19) broadly defines the term "digital asset" as "any digital representation of value that is recorded on a cryptographically secured distributed ledger (or any similar technology), without regard to whether each individual transaction involving that digital asset is actually recorded on that ledger, and that is not cash." Although POSA has intentionally focused its comments on the staking-related aspects of the Proposed Rule, POSA submits that the proposed definition of "digital asset" is overly broad because it would capture digital instruments that are not ordinarily regulated as "digital assets" (*e.g.*, gift cards, digital media), which businesses track using computer systems that incorporate a distributed ledger and cryptography.

10 *See, e.g.*, James Kent, *Commentaries on American Law* 432 (1826) ("The words of a statute are to be taken in their natural and ordinary signification and import; and if technical words are used, they are to be taken in a technical sense.").

into effect or operation."[11] Black's Law Dictionary does not include a definition of "effectuate" but defines its root term "effect" to mean "[t]o bring about; to make happen."[12] As discussed further in Section II below, a validation service or software provider does not "effectuate" transfers of digital assets, but merely confirms that transfers of digital assets effectuated by persons who control the private key to the digital wallet containing such digital assets are valid.

Finally, long-standing Treasury Department and IRS regulations use the word "effect" rather than "facilitate." Under existing IRC § 1.6045-1, "effect" means to act as an "*agent for the party in the sale* wherein the nature of the agency is such that the agent ordinarily would know the gross proceeds from the sale." Congress solely intended to clarify that this definition applied to such persons in the case of digital asset transactions and would have understood that persons providing validation services do not act as an agent for a party to a sale in digital assets. The Treasury Department and IRS have never asserted that web infrastructure service providers, like Amazon Web Services, or domain name registry services, like GoDaddy, are responsible for collecting and reporting tax information if such providers run servers or maintain a domain name registration on behalf of a person who generates revenue from content made available through such services. The concept of facilitation is sufficiently broad to capture virtually every software and hardware provider that is indirectly connected to the effectuation of a digital asset transaction, including personal computer manufacturers, internet service providers and web browser developers.

Neither the text of the Act nor the Congressional record supports the conclusion that "effectuate" should be interpreted by the Treasury Department and IRS to mean "facilitate." As a result, the Proposed Rule exceeds the Treasury Department and IRS's statutory authority under the Act in violation of the Administrative Procedure Act (the "**APA**").[13]

II. Make Clear that "Facilitative Service" Does Not Include StaaS Providers and LS Providers

POSA respectfully urges the Treasury Department and IRS to align the Proposed Rule with Congressional intent by making clear that StaaS Providers and LS Providers are persons that solely engage in the business of providing validation services and are therefore not "brokers," irrespective of whether such persons offer "other functions and services" that are related to such validation services.

Ethereum, Solana, Cosmos and many other popular blockchains utilize a proof-of-stake consensus mechanism to assure that transactions added to the distributed ledger are valid and ordered correctly. Any holder of a proof-of-stake blockchain's native digital asset can contribute to the security of the network by operating a validator node, signing a transaction with their private key to temporarily commit (or "stake") digital assets allocated to such node, and validating transactions in accordance with the rules of the network. The digital asset holder earns rewards in the form of additional units of the native digital asset from the blockchain network ("**Network Rewards**") for operating the validator node in accordance with network rules, but risks losing such digital assets in the event that the holder fails to operate the node in accordance with network rules (known as a "slashing event"). This system incentivize stakers to allocate staked assets to a validator node that acts honestly and in accordance with network rules. As a greater number of digital

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[11] Merriam-Webster Online, effectuate, *available at* https://www.merriam-webster.com/dictionary/effectuate (last accessed November 3, 2023).

[12] BLACK'S LAW DICTIONARY (11th ed. 2019), effect.

[13] The APA requires courts to "hold unlawful and set aside agency action, findings, and conclusions" that are "in excess of statutory jurisdiction, authority, or limitations," or "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A), (C)–(D).

asset holders stake digital assets to honest validator nodes, it becomes more difficult for a malicious actor to obtain a sufficient amount of digital assets to attack the network.

It is a technological reality that only the holder of the private key to a digital wallet containing digital assets can sign a transaction authorizing and thereby effectuating the staking or transfer of digital assets contained in such digital wallet. The validator nodes on a proof-of-stake network confirm such person's transactions, but no validator node has the authority to effectuate a transaction on behalf of a digital asset owner. Validators confirm the validity of transactions effectuated by private key holders.

Technology vendors offer various non-custodial products and services designed to simplify the process of staking digital assets through proof-of-stake networks. For example, StaaS Providers provide technical services to participants in proof-of-stake networks who stake digital assets but prefer to delegate the responsibility for running the requisite validator node hardware and software to a third party. Customers of StaaS Providers are responsible for the custody of their digital assets and manage the digital assets that they stake in connection with the validator node. Similar to a web infrastructure provider, such as Amazon Web Services, that is tasked with keeping servers online on behalf of customers, the StaaS Provider is retained to keep the validator node software and hardware online and running in accordance with the relevant proof-of-stake network protocol. However, the customer is solely responsible for maintaining the private keys associated with the digital wallet that holds the staked digital assets.

Additionally, validation services providers have developed novel technological infrastructure to allow stakers to transfer legal and beneficial ownership of the digital assets that they have staked without first unstaking such digital assets. For example, LS Providers offer software that enables users to stake digital assets by transferring such assets to a non-custodial smart contract that allocates the assets to a validator node run by a StaaS Provider and provides to the user a cryptographic receipt token evidencing legal and beneficial ownership of the staked digital assets and any Network Rewards that accrue to such assets.[14] The receipt token is akin to a digital document of title that verifies the customer is staking a specified amount of digital assets through a liquid staking software protocol. The receipt token is redeemable for the associated staked digital assets plus any Network Rewards that accrue to such digital assets, less any amounts lost due to slashing.

Many validation services and software providers offer to their customers certain ancillary services and features that are integral to the provision of validation services or software. For example, liquid staking software is designed to allow users to stake digital assets and receive a cryptographic receipt token that represents the staker's legal and beneficial ownership of staked digital assets. Additionally, it is typical for StaaS Providers and LS Providers to make available to customers a graphical user interface that allows the customer to manage aspects of the staking process. StaaS Providers often offer a customer dashboard that enables the customer to stake and unstake digital assets and modify the configuration of the customer's validator node. Similarly, LS Providers commonly offer a web interface that enables the user to stake digital assets and redeem receipt tokens for staked digital assets. Moreover, StaaS Providers and LS Providers oftentimes offer to customers coverage against the risk of losing digital assets due to a slashing event. The slashing coverage is usually provided by a third party coverage provider for the benefit of the user.

As explained in Section I above, the Proposed Rule contravenes Congressional intent because it does not adequately exclude validation services and software providers from regulation as "brokers."

[14] "Similar to a ticket that one receives after checking one's coat at a coat check, which represents one's claim on a coat, Receipt Tokens merely represent a claim on the Liquid Staker's staked cryptoassets rather than a new entitlement." *See* Proof of Stake Alliance, *U.S. Federal Income Tax Analysis of Liquid Staking* (Feb. 21, 2023), *available at* https://www.proofofstakealliance.org/s/US_Federal_Income_Tax_Analysis_of_Liquid_Staking.pdf.

Instead, the Proposed Rule leaves open the possibility that any validation services or software provider who offers "other functions and services" may be deemed a "broker." While it would not be reasonable to exclude from the definition of "broker" persons that would otherwise be a "broker" but for the fact that such persons offer validation services, the validation services exclusion should be sufficiently broad to accomplish the stated objective of excluding validation services and software providers that solely provide other functions and services that are integral to the provision of validation services.

In particular, the inclusion of "other functions and services" within the validator services exclusion would leave open that possibility that StaaS Providers and LS Providers may be deemed "brokers" because such providers typically offer features such as a graphical user interface, slashing coverage and/or cryptographic receipt tokens. POSA strongly recommends that the Treasury Department and IRS make clear that the validation services exclusion from the definition of "facilitative services" is applicable to StaaS Providers and LS Providers that solely provide functions and services that are integral to validation services.

III. The Proposing Release Fails to Adequately Consider the Economic Cost of Applying the "Broker" Requirements to StaaS Providers and LS Providers

The Proposing Release fails to adequately consider the economic cost of applying regulations designed for financial intermediaries to validation services and software providers that do not custody or transact in digital assets on behalf of users. POSA believes that the Proposed Rule, if adopted in its current form, would have a significant adverse impact upon both proof-of-stake blockchains and holders of the digital assets that operate on these networks.

It is increasingly common for users of proof-of-stake blockchain networks to participate in network consensus by staking digital assets. Indeed, users of the top thirty-five proof-of-stake blockchains have a combined total of approximately $73.5 billion worth of digital assets staked through these networks as of Q4 2023, up from approximately $42 billion in Q4 2022.[15] Many of these users opt to contract with vendors, such as StaaS Providers, to keep the requisite hardware and software online, just as it is common for both consumers and institutions to retain vendors to provide traditional web hosting services. A large swath of users do so through a liquid staking protocol developed by an LS Provider that programmatically allocates the user's digital assets to a validator node maintained by a StaaS Provider. The Proposed Rule, if adopted in its current form, would leave open the possibility that StaaS Providers and LS Providers must comply with "broker" reporting obligations or cease doing business with American customers.

POSA believes that a significant number of StaaS Providers and LS Providers would opt for the latter course. Such an outcome would be catastrophic for proof-of-stake blockchains and the holders of digital assets on such networks A significant portion of the roughly $73.5 digital assets staked through the most popular networks today are staked by Americans through StaaS Providers and/or LS Providers. Adoption of the Proposed Rule could therefore result in the unstaking of a massive amount of digital assets, which would impair the security of the underlying proof-of-stake blockchains. Stakers that allocate digital assets to a validator node are incentivized to operate the validator node honestly and in adherence with network rules (or retain a StaaS Provider that will do so on such person's behalf) by the threat of slashing and opportunity to earn Network Rewards. So long as the majority of validator nodes on the network act honestly and in accordance with network rules, any malicious actors who fail to do so will be punished.

By adopting the Proposed Rule, the Treasury Department and IRS would effectively mandate that the security forces of these proof-of-stake networks leave the field, allowing malicious actors to take

[15] Staked, *The State of Staking* (Q4 2023), *available at* https://staking.staked.us/state-of-staking.

control. The barrier to a malicious actor amassing a sufficient quantity of digital assets to manipulate transactions on any given proof-of-stake network would be significantly lowered if a large portion of Americans' digital assets were to be unstaked. If users do not have adequate assurances that transactions on the network will not be manipulated or reversed, the digital assets on these networks would have questionable utility or value. As a result, the Proposed Rule risks not only undermining the continued functioning of proof-of-stake networks but also the value of the digital assets that operate on these networks.

The current market capitalization of all digital assets today is approximately $1.34 trillion[16] and the vast majority of digital assets operate on proof-of-stake networks. A mass unstaking of digital assets upon the effective date of the Proposed Rule could cause a cascading series of events that results in substantial harm to users of proof-of-stake networks and destroys the value of many of the most widely used digital assets. There is no discussion of these potentially existential risks to proof-of-stake blockchains and digital assets in the Proposing Release. Accordingly, POSA submits that the Treasury Department and IRS have failed to adequately consider the economic costs of the Proposed Rule as required by the APA.

IV. Recommendations

POSA urges the Treasury Department to consider amending the Proposed Rule to more clearly exclude validation services and software providers from the "broker" definition and postpone the effective date of any final rule to at least two years from the date of publication in the Federal Register.

First, we recommend that the Treasury Department amend the Proposed Rule's reference to "other functions or services" to read "other functions or services *that are not integral to the provision of validating services or software*." The Treasury Department's Financial Crimes Enforcement Network uses similar terminology within the definition of a "money transmitter" under its anti-money laundering regulations to distinguish between persons that transmit money incidentally as part of providing a good or service and persons that transmit money on behalf of customers as a business.[17] The latter are money transmitters whereas the former are not because such persons provide a service other than money transmission and any transmission is incidental to providing this service. Similarly, validation services and software providers that provide validation services to customers together with services and functions that are integral to the validation services but are not standalone services that could be broken off from the validation service, such as a graphical user interface, slashing coverage or cryptographic receipt token, should not be regulated as "brokers."

Second, if the Treasury Department and IRS finalize the Proposed Rule in its current form, we urge the Treasury Department and IRS to postpone the effective date of such finalized rule to at least two years from the date such finalized rule is published in the Federal Register. We understand based on discussions with our membership that validation services and software providers would require at least two years to make the significant technological changes needed to facilitate collection of the information required to be collected under the Proposed Rule. This reprieve would permit the digital asset industry to develop and implement the technology necessary to comply with the Proposed Rule.

The IRS has historically acknowledged the difficulties in implementing new reporting regimes and permitted would-be brokers a grace period to establish and implement effective means of complying with such regimes. For example, on December 12, 2010 the IRS released Notice 2010-67 in connection with

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[16] Forbes, *Cryptocurrency Prices Today By Market Cap*, *available at* https://www.forbes.com/digital-assets/crypto-prices/?sh=3f0718262478 (last accessed Nov. 3, 2023).

[17] *See Bank Secrecy Act Regulations - Definitions and Other Regulations Relating to Money Services Businesses*, 76 Fed. Reg. 43585, 43594 (July 21, 2011).

proposed regulations being finalized that would require brokers and other custodians to report basis information.[18] "In order to promote industry readiness to comply with the reporting requirement" of the finalized regulations, Notice 2010-67 tolled the assertion of penalties under Section 6722 for the applicable sales occurring in the year following the release of the final regulations, except in connection with transfers that the industry conceded they were currently equipped to acquire the necessary information.

The Proposed Rule raises similar concerns as those addressed in Notice 2010-67, and warrants providing potential brokers with a similar grace period. However, given the complexity of the technology utilized to stake digital assets as well as the fact that the Proposed Rule subjects entirely new actors to information reporting obligations (as compared to expanding the obligations of persons presently subject to information reporting), we request that the Treasury Department and IRS provide more robust relief than that of Notice 2010-67.

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POSA appreciates the Treasury Department and IRS's consideration of our comments and would be pleased to engage with the Treasury Department and IRS as the Proposed Rule develops. If you have questions or would like to discuss these comments further, please reach out to us at alison@proofofstakealliance.org.

Sincerely,

Alison Mangiero
Executive Director, Proof of Stake Alliance

cc: Roger Wise
Michael Selig
Willkie Farr & Gallagher LLP

[18] *Information Reporting Requirements Relating to Transfers of Securities*, Notice 2010-67 (Dec. 12, 2010).