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Invested in America

September 13, 2024

[VIA ELECTRONIC SUBMISSION]
Erika Nijenhuis
U.S. Department of Treasury
1500 Pennsylvania Ave, NW
Washington, DC 20220

Re: Information Reporting and Withholding with respect to Digital Asset ETFs

Dear Ms. Nijenhuis:

SIFMA[1] appreciates the opportunity to provide comments regarding brokers' information reporting and withholding responsibilities with respect to exchange traded funds ("ETFs") that seek to track the performance of bitcoin or ether by holding spot bitcoin ("Bitcoin ETFs") or spot ether ("Ether ETFs"). Since the SEC approved the listing of Bitcoin ETFs in January 2024 and Ether ETFs in July 2024, billions of dollars have flowed into these ETFs ("Digital Asset ETFs").[2] However, the information reporting and withholding rules that govern Digital Asset ETFs organized as grantor trusts that are widely held fixed investment trusts ("WHFITs") are unclear, and brokers need additional guidance in order to comply with regulatory requirements.

[1]SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

[2] See, e.g., Winners and Losers In the Spot Bitcoin ETF Race | Morningstar.

I. Withholding on Receipt of Incidental Rights and Assets with Respect to Non-U.S. Holders

From time to time, Digital Asset ETFs may become entitled to receive (i) rights to acquire digital or other assets as a result of their ownership of digital assets, and/or (ii) actual digital or other assets through the exercise of such rights (collectively, "Incidental Assets"). For example, an airdrop may be offered to holders of digital assets, or the blockchain could undergo a hard fork, resulting in digital asset holders receiving a new digital currency. Brokers require guidance with respect to several aspects of analysis relating to potential withholding tax on a Digital Asset ETF's receipt of an entitlement to Incidental Assets.

A. Abandonment

Many Digital Asset ETF prospectuses[3] provide that (i) the Digital Asset ETF will permanently and irrevocably abandon any Incidental Assets, (ii) the holders will not receive the economic benefit of any Incidental Assets, and (iii) the only digital asset that will be held by the ETF is bitcoin or ether, as the case may be.[4] This arrangement should result in the Digital Asset ETF, and therefore a holder of a Digital Asset ETF, not recognizing any income for U.S. tax purposes. If a holder does not recognize any income, a broker will not be required to withhold U.S. tax with respect to any Incidental Assets. However, certain prospectuses[5] also note that there can be no assurance that these abandonments would be respected by the IRS or treated as effective for U.S. federal income tax purposes. If the IRS does not respect the abandonment arrangement, it is not clear whether the deemed receipt of the entitlement to Incidental Assets constitutes U.S. source fixed or determinable annual or periodical ("FDAP") income subject to U.S. nonresident alien or FATCA withholding when deemed received by a non-U.S. person, and if it does, how and when a broker should withhold, given the uncertainties described in more detail below. The IRS should respect the abandonment given that the Digital Asset ETF (and its holders) will not receive the economic benefit of any Incidental Assets.

In Revenue Ruling 2019-24 the IRS addressed whether a taxpayer has gross income as a result of a hard fork of a cryptocurrency that the taxpayer owns if the taxpayer does not receive units of a new cryptocurrency. The Revenue Ruling states, "A taxpayer does not have receipt of cryptocurrency when the airdrop is recorded on the distributed ledger if the taxpayer is not able to exercise dominion and control over the cryptocurrency." The IRS therefore concluded that if the taxpayer did not receive units of the new cryptocurrency from the hard fork, it does not have an accession to wealth and does not have gross income as a result of the hard fork. Similarly, the Digital Asset ETF (and its holders) should not be considered to have received any gross income if the Digital Asset ETF abandons the Incidental Assets.

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[3] See, e.g., bit20240606_424b3.htm - p-ishares-bitcoin-trust-12-31.pdf.

[4] Some prospectuses note that the Bitcoin ETF sponsor can change this policy only via an application by the exchange to the SEC.

[5] See, e.g., supra note 4.

If the abandonment is respected, the correct economic result is achieved (i.e., no income recognition or tax borne by holders), and the withholding tax ambiguity and complexity is eliminated. Because this critical issue remains unclear, the IRS should issue guidance providing whether and under what circumstances the IRS will respect an arrangement pursuant to which a Digital Asset ETF abandons Incidental Assets.

B. Characterization as U.S. Source FDAP Income

If the IRS does not respect the abandonment or does not provide guidance with respect to the abandonment, brokers will be required to analyze whether receipt of the entitlement to Incidental Assets gives rise to a withholding obligation. Although the IRS ruled in Revenue Ruling 2019-24[6] that a hard fork gives rise to ordinary income for U.S. federal income tax purposes, existing IRS guidance does not address whether income recognized as a result of an airdrop, hard fork or similar event is *U.S. source FDAP* income subject to U.S. withholding tax. When the source of an item of income is not specified by statute or regulations, the courts have determined the source of the item by comparison and analogy to classes of income for which the source of income is specified by the Internal Revenue Code (the "Code").[7] The IRS has applied the same approach in ruling on the source of items of income not addressed in the Code or regulations.[8] Analogizing to other types of income, however, is difficult given the uniqueness of blockchains and digital assets. Lack of IRS guidance will result in brokers performing a case-by-case analysis which could give rise to under-or over-withholding on non-U.S. customers and could lead to inconsistent treatment among brokers and confusion among taxpayers. The IRS should publish guidance with respect to income from airdrops, hard forks and similar events as to how to determine the source of such income. In most cases it is virtually impossible to identify a particular geographic location in which the entitlement to the Incidental Asset was generated or took place. There is often no identifiable payor responsible for the payment, and no particular person may bear the cost, so it would be inappropriate to source the payment to the payor. Because conventional methods of determining the source of income (e.g., residence of the payor) do not apply to hard forks and airdrops, we recommend that the source of such income should be based on the residence of the recipient, applying the principles of Treas. Reg. 1.863-7(b) which generally apply to notional principal contracts. This would provide a means with which to make an objective source determination.

C. Reliance on Grantor Trust Tax Information Statement/Timing Issues

If brokers need to address U.S. withholding tax on non-U.S. holders because the IRS does not respect the abandonment or does not provide guidance with respect to the abandonment, it is not clear how brokers would determine whether or not a holder has received income from an Incidental Asset that is subject to U.S. withholding tax. Because the Digital Asset ETF would have abandoned the Incidental Assets, no distribution of Incidental Assets (or cash related to such Incidental Assets) will be made to holders, nor would such amounts be reflected on the

[6] 2019-44 IRB 1004 (10/9/2019).

[7] See, e.g., Bank of America v. United States, 680 F.2d 142 (Ct. Cl. 1982).

[8] See Rev. Rul. 2009-14; Rev. Rul. 2004-75.

balance sheet of the Digital Asset ETF. In addition, income related to any Incidental Assets will likely not be reported by the Digital Asset ETF on the grantor trust tax information statement that provides the trust interest holder's allocable portion of the Digital Asset ETF's annual income, gain, losses and expenses.[9] Presumably, a broker can rely on the grantor trust tax information statement to determine whether or not holders recognize any income related to Incidental Assets (particularly where the broker has no reason to know that the statement is incorrect), but the IRS should clarify this with explicit guidance.

Even if brokers may rely on grantor trust tax information statements to determine whether or not holders recognize income subject to U.S. withholding tax, it is not clear whether a broker should withhold tax on a foreign holder if a grantor trust tax information statement reports income from an abandoned Incidental Asset. Because the income was not distributed, there would be no cash to withhold from. If a broker were required to sell a portion of a holder's Digital Asset ETF shares in order to fund the withholding, there would be a timing problem. Grantor trust tax information statements are issued in the first months of the year following the relevant tax year. For example, if a Digital Asset ETF received an entitlement to an Incidental Asset on January 2, 2024, and if the Digital Asset ETF treated the entitlement receipt as income allocable to the holders on the grantor trust reporting statement, a broker would not find out about it until such statement is issued in the first quarter of 2025. By then the non-U.S. holder may have already redeemed its interest in the Digital Asset ETF, and/or may no longer be a customer of the broker, leaving the broker with no cash to withhold on and deposit with the IRS. A broker has no notice of the income event in real time, and therefore would not be in a position at the time of the income event to hold back and reserve assets or cash for future withholding. The IRS should therefore provide that until guidance is issued with respect to the source of income from Incidental Assets, brokers are not required to withhold with respect to such income. In addition, if guidance is issued and if pursuant to that guidance a Digital Asset ETF holder who is not a U.S. person is deemed to receive U.S. source FDAP income as a result of the receipt by a Digital Asset ETF of an entitlement to Incidental Assets, the IRS should (i) delay the requirement for brokers to withhold on such income until six months after the due date for the issuance of grantor trust tax information statements and (ii) provide that brokers shall have no obligation to withhold on such amounts to the extent that they do not have custody or control over money or property of the taxpayer when the withholding tax becomes due.

II. Form 1099 Reporting

In Section II.A. of our November 13, 2023 comment letter[10] on the proposed digital asset reporting regulations[11] (the "Proposed Regulations"), we requested that the IRS provide additional guidance to clarify the appropriate Form 1099 reporting of transactions in and by Bitcoin ETFs. The IRS and Treasury made certain clarifications addressing ETFs in the preamble

[9] See Treas. Reg. § 1.671-5(e) regarding grantor trust tax information statements.

[10] Proposed Regulations for Gross Proceeds and Basis Reporting by Brokers and Determination of Amount Realized and Basis for Digital Asset Transactions (sifma.org).

[11] REG 122793-19, 88 Fed. Reg. 59576 (Aug. 29, 2023).

to the final digital asset reporting regulations (the "Final Regulations") [12] released on June 28, 2024, but there are some issues that we believe require additional guidance.

A. Sales of Interests in a Digital Asset ETF

Prospectuses generally disclose that a Digital Asset ETF will be treated as a grantor trust for U.S. federal income tax purposes.[13] We expect (and certain prospectuses disclose) that they will also be treated as WHFITs. Holders of interests in grantor trusts are generally treated as directly owning their pro rata share of the underlying assets of the trust. We agree with the preamble to the Final Regulations, as well as the "fund" example in those regulations, [14] that because Digital Asset ETFs that are grantor trusts are expected to be WHFITs and interests in trusts are "securities" for Form 1099-B purposes,[15] a sale of an interest in a Digital Asset ETF should be treated as a sale of a security and reported on Form 1099-B. Consequently, a broker should not be required to treat a sale of a trust interest as a reportable sale of the digital assets held by the trust. In addition, because interests in trusts are not "covered securities" for purposes of Form 1099-B reporting,[16] cost basis and acquisition date information are not required to be reported with respect to sales of interests in Digital Asset ETFs.

B. Sales of Digital Assets by a Digital Asset ETF

1. Form 1099-DA reporting applies only to brokers that "take possession" of the underlying digital assets

Digital Asset ETFs are expected to sell a portion of the digital assets they hold to pay expenses of the ETF. The preamble to the Final Regulations states, generally, that a broker is required to report the sale of digital assets by a Digital Asset ETF as a sale of digital assets by the holder of a Digital Asset ETF on Form 1099-DA.[17] This preamble statement, however, conflicts with the guiding principle of TD 10000: ***that Form 1099-DA reporting is required by brokers only when they "take possession" of the digital assets being sold.*** This guiding principle first appears on page 56492 of the preamble, which states:

> Under these rules, certain digital asset industry participants that *take possession* of a customer's digital assets, such as custodial digital asset trading platforms [etc., etc.] would also generally be considered brokers with respect to digital asset sales (emphasis added).

[12] T.D. 10000, IRS Final Rule on Gross Proceeds and Basis Reporting by Brokers and Determination of Amount Realized and Basis for Digital Asset Transactions, 89 Fed. Reg. 56840 (July 09, 2024).

[13] We note that at least one Bitcoin ETF has disclosed that it is treated as a partnership for U.S. federal income tax purposes.

[14] Treas. Reg. § 1.6045-1(b)(20), Example 20.

[15] Treas. Reg.§ 1.6045-1(a)(3)(ii).

[16] Treas. Reg. § 1.6045-1(a)(15).

[17] TD 10000, 89 Fed. Reg. 56480, 56490 (July 9, 2024). See also Treas. Reg. § 1.6045-1(d)(9).

This guiding principle is repeated on page 56493:

> Taken together, these final regulations apply only to digital asset industry participants that *take possession* of the digital assets being sold by their customers, such as operators of custodial digital asset trading platforms, certain digital asset hosted wallet providers, certain PDAPs, and digital asset kiosks, as well as to certain real estate reporting persons that are already subject to the broker reporting rules (emphasis added).[18]

Similarly, the regulations define a broker as "a person that effects sales of digital assets on behalf of others…."[19] This standard is consistent with limiting the scope of "broker" to only those persons that take possession of a digital asset.

In sharp contrast to these clear statements, the preamble nonetheless also states:

> if a WHFIT sells a digital asset, and interests in the WHFIT are held through a securities broker, the WHFIT would report the sale information to the broker pursuant to § 1.671-5 and the broker would in turn send a Form 1099-DA (the appropriate Form 1099) to the IRS and a copy thereof to any trust interest holder that is not an exempt recipient.[20]

It is unclear how the preamble reaches this conclusion for WHFITs, unless the above statement incorrectly assumes a securities broker who holds an interest in a Digital Asset ETF for a customer generally takes possession of the underlying digital assets. We recommend additional guidance to clarify that, in the more typical scenario where a broker does not take possession of the underlying digital assets, the "appropriate" Form 1099 under Treas. Reg. § 1.671-5(d)(1)(i)(B) would include Form 1099-B.

The just-published draft instructions to Form 1099-DA allow a broker to use either Form 1099-B or -DA to report a disposition of digital assets held by a WHFIT. The draft instructions on page 4 say, "You may choose to report this disposition of digital assets on either Form 1099-B or Form 1099-DA." However, in the next sentence, the draft instructions seem to contradict the availability of a choice and require Form 1099-DA reporting to a trust interest holder:

> For digital asset sales, trustees and middlemen must report the amount of non-pro rata partial principal payments (as defined in Regulations section 1.671-5(b)(13)) and trust sales proceeds (as defined in Regulations section 1.671-5(b)(21)) attributable to a trust interest holder (TIH) for the calendar year on Form 1099-DA.

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[18] TD 10000 at 56493.

[19] Treas. Reg. § 1.6045-1(g)(4)(i)(A).

[20] TD 10000 at 56490. Notably, the regulations themselves do not specify a form to use when a WHFIT sells its assets.

The subsequent paragraphs provide specific instructions for how to complete Form 1099-DA under these circumstances.

We are in full agreement that brokers should be able to choose to use Form 1099-B to report dispositions of digital assets by WHFITs. However, brokers also should be able to report to trust interest holders with respect to partial principal payments and trust sales proceeds for digital asset sales by WHFITS on Form 1099-B when the de minimis exception does not apply (as discussed below).

Furthermore, to the extent a securities broker does take possession of digital assets, any Form 1099-DA reporting should be limited to transactions relating to those assets only. Any incidental possession of digital assets should not, therefore, result in the securities broker being subject to Form 1099-DA reporting to trust interest holders.

Finally, we ask that the Instructions for Form 1099-B be updated to reflect that the Form 1099-B is the more appropriate Form 1099 to complete reporting for trust interest holders of WHFITs. The recent draft Instructions for Form 1099-B for 2025 contain language that indicate that Form 1099-DA is the appropriate Form 1099 for brokers of a trust interest holder to report dispositions of digital assets by a WHFIT, however we believe that brokers for trust interest holders should be able to report such dispositions of digital assets by a WHFIT on Form 1099-B. The burden placed on the industry, for traditional brokers who have actively avoided in dealing in digital assets, outweighs the benefit of reporting on Form 1099-DA in this instance. Form 1099-B reporting would give the taxpayer and IRS enough information to determine income and taxes owed while not subjecting traditional brokers to having to build a Form 1099-DA process that would be required only if the WHFIT sales of digital assets exceeded the de minimis threshold.

2. Application of WHFIT reporting exceptions

The WHFIT statement in the preamble does not take into account a significant exception to a broker's obligation to report sales of assets by a WHFIT. In general, a "middleman," which includes a custodian such as a bank, financial institution, or brokerage firm acting as custodian of an account,[21] is required to report certain WHFIT related information on "the appropriate Form 1099."[22] This includes reporting the amount paid to a WHFIT for the sale or disposition of an asset held by the WHFIT ("trust sales proceeds").[23] However, if a non-mortgage WHFIT satisfies a de minimis test such that trust sales proceeds for the calendar year are not more than 5% of the net asset value of the trust as of a certain date (the "de minimis test"),[24] reporting with respect to trust sales proceeds is required to include only trust sales proceeds that are distributed

[21] Treas. Reg. § 1.671-5(b)(10).

[22] Treas. Reg. § 1.671-5(d)(1)(i)(B).

[23] Treas. Reg. § 1.671-5(b)(21), (d)(2)(ii)(E).

[24] Treas. Reg. § 1.671-5(c)(2)(iv)(B), (D)(1).

to the trust interest holder.[25] It appears that the expense ratios of Digital Asset ETFs will be set significantly below 5%, meaning that it is unlikely that a Digital Asset ETF will exceed the threshold of the de minimis test. It also appears that Digital Asset ETFs do not intend to make distributions to holders. If a Digital Asset ETF sells digital assets to pay trust expenses (or for other reasons), satisfies the de minimis test, and does not distribute the proceeds of the digital asset sales to holders, a middleman should not be required to report that sale on any Form 1099.

The IRS should issue clarifying guidance regarding WHFIT reporting discussed in the preamble to note this very material exception to reporting. The IRS should issue additional guidance confirming that if a Digital Asset ETF that is a WHFIT for U.S. tax purposes has an expense ratio that does not exceed the threshold of the general de minimis test upon a sale or disposition of the assets of the Digital Asset ETF the proceeds of which are not distributed to holders, then a trustee or middleman is not required to report underlying sales of digital assets by the Digital Asset ETF on Form 1099-B or Form 1099-DA, even if the trust chooses, in an abundance of caution, to report the trust sales proceeds on a grantor trust tax information statement or otherwise.[26] Issuing this additional guidance would significantly reduce the burden on brokers who otherwise might feel compelled to issue Forms 1099 for de minimis transactions.

In the event a broker who is not a digital asset broker is required to report a sale of digital assets by a Digital Asset ETF, that reporting should be permitted on Form 1099-B. As noted above, the Form 1099-DA will be directed to custodial digital asset brokers and others who actually receive digital assets in the course of their business. Traditional securities brokers are not in that category. Traditional securities brokers provide clients access to the securities markets, and some of those securities are interests in Digital Asset ETFs, but generally they do not custody the digital assets of their clients, including trust interest holders. In addition, given the high volume of Form 1099 reporting, traditional securities brokers cannot wait until reporting season to see if Form 1099-DA will be required. On the other hand, the cost of implementing a new form type on the platforms of traditional securities brokers (which may rarely be used due to the de minimis test) would be disproportionate to any perceived benefits to the IRS of receiving Form 1099-DA rather than Form 1099-B with respect to an asset – the WHFIT – which is itself not a digital asset. These implementation costs are further discussed in our November 13, 2023, comment letter on the proposed digital asset reporting regulations.[27]

Many traditional securities brokers do not (and do not expect to) facilitate digital asset transactions, and would otherwise have no reason to implement a costly Form 1099-DA reporting system. Many of our members rely on third-party vendors to provide and process data regarding WHFIT transactions which in turn feed tax reporting systems which are also often

[25] Treas. Reg. § 1.671-5(d)(2)(i); -5(d)(2)(ii)(E).

[26] See Treas. Reg. § 1.671-5(c)(2)(iv)(B), (D)(1).

[27] Proposed Regulations for Gross Proceeds and Basis Reporting by Brokers and Determination of Amount Realized and Basis for Digital Asset Transactions (sifma.org). Available at: Proposed Regulations for Gross Proceeds and Basis Reporting by Brokers and Determination of Amount Realized and Basis for Digital Asset Transactions - SIFMA - Proposed Regulations for Gross Proceeds and Basis Reporting by Brokers and Determination of Amount Realized and Basis for Digital Asset Transactions - SIFMA

vendor platforms. Vendors will also be required to implement changes to their systems to accommodate Form 1099-DA reporting, compounding the expense and also prolonging the implementation timeline for brokers with respect to these changes. Merely providing for trading and custody of a Digital Asset ETF, a traditional securities product, should not cause a traditional securities broker to be required to update reporting systems to accommodate Form 1099-DA. Further, the core information that brokers would be required to include on Form 1099 (date of disposition, trust sale proceeds and information that allows holders to allocate a portion of their basis to the sale)[28] can easily be included on written tax information statements to holders and Form 1099-B. Finally, it is not apparent that WHFIT trustees would make available the information that would be necessary to enable brokers to complete some of the boxes that are unique to Form 1099-DA.

It appears that the IRS made the judgement that a new form was required to report digital asset sales by taxpayers because the environment in which those sales typically take place is not regulated to the same degree as traditional brokerage accounts, and the ability of a taxpayer to transfer tokens from its account at a broker to its own wallet, and then to another broker or perhaps a decentralized finance platform, present unique enforcement challenges. None of these enforcement challenges are reflected in sales of digital assets by Digital Asset ETFs. The transactions are straightforward sales by regulated entities for the purpose of paying management fees. Our customers have no ability to control or influence those transactions, let alone transfer tokens. Accordingly, the case for requiring these transactions to be reported on Form 1099-DA is weak, while the operational expense of using Form 1099-DA would be significant. Therefore, traditional brokers should be allowed to report using their existing processes for WHFIT reporting.

In the event that Treasury and the IRS conclude that traditional securities brokers must implement Form 1099-DA to cover potential digital asset sales by Digital Asset ETFs, they should allow a significant transitional relief period before Forms 1099-DA are required to be issued, during which brokers may report the required information on Form 1099-B. As noted above, financial institutions and vendors would need to make significant systems changes to accommodate this new report.

III. Conclusion

SIFMA appreciates your consideration of our comments regarding Digital Asset ETF information reporting and withholding issues, and welcomes the opportunity to discuss the issues in this submission with you and your colleagues. Please do not hesitate to contact P.J. Austin (paustin@sifma.org) or our outside advisors, Tara Ferris (tara.ferris@ey.com), Jonathan Jackel (jonathan.jackel@ey.com), Seth Poloner (seth.poloner@ey.com) and Ryan Blewitt (ryan.blewitt@ey.com).

[28] Treas. Reg. § 1.671-5(e)(2)(v)(A).

Respectfully Submitted,

P.J. Austin

Vice President, Tax

cc: [Roseann Cutrone, Special Counsel, IRS
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