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

By Lani Chou, Cyrus Daftary, Philip Garlett, Nelson Suit, and Joshua Tompkins

This article highlights potential impacts of the proposed U.S. broker digital asset tax reporting regulations on online gaming companies.

Online gaming companies operate under different models, and some utilize digital assets such as digital tokens or nonfungible tokens (NFTs) as a part of their business model. As such, the impact of these rules will vary depending on the business model utilized by the gaming company, the types of marketplaces and digital tokens that are used in connection with the gaming platform, and what players may be allowed to do on a given gaming platform.

This article is general in nature, and further assessment of the rules against a business's particular facts will need to be conducted to determine 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 were 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, online gaming platforms that utilize digital assets, 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 online gaming marketplaces?

The online gaming industry has made extensive use of digital assets in the form of gaming tokens and nonfungible tokens (NFTs) with different and creative applications. Certain digital tokens and NFTs may include rights to gameplay access, or they may be exchanged for other digital tokens within the same online gaming site. Some may also be allowed to be exchanged for cash or goods. In addition, some of these digital tokens or NFTs can also be bought, sold, or traded through secondary market trading platforms for cash or for different digital tokens or NFTs. NFTs or gaming tokens may be sold on the gaming platform or they may be issued to users in a play-to-earn (P2E) model.

To the extent these offerings involve digital assets, the activities can trigger the broker crypto tax reporting rules and cause the gaming platform to be treated as a broker required to report digital asset sales under the proposed regulations.

Where an online gaming site regularly offers to redeem its digital assets, for cash or goods from the game issuer, the proposed regulations may treat such digital asset redemptions as broker reportable transactions. Additionally, online gaming sites may allow for digital assets to be redeemed by the gaming company issuer in exchange for cash or goods from third party merchants. In such a case, depending on the structure of the arrangement, the online gaming company could also have broker reporting obligations if it is acting as a Digital Asset Payment Processor in the ordinary course of its business to regularly facilitate payments between the players and the merchants.

Online gaming sites, such as online gambling sites, may provide players with the opportunity to deposit their digital assets into an account or into a hosted wallet which is then credited with an amount of cash equal to the value of the digital asset at the time of the deposit. The online gaming site may immediately dispose of the deposited digital assets in exchange for cash. When the player is ready to withdraw funds from its account, it can receive cash or newly acquired digital assets equal to the current value of its account (which may have been increased or decreased due to the gameplay). Under these circumstances, it is possible that the online gaming company would be considered a broker, and the sale of the deposited digital assets on behalf of the depositing player could be treated as a reportable sale. The same could be true if the player reacquires digital

assets in the account and later disposes of some of those digital assets through the account (also resulting in possible additional “covered” digital asset basis reporting).

An online gaming site may provide an internal trading platform for its players to trade the multiple NFTs and digital tokens related to that online gaming site, in which case it may be treated as a broker under the proposed reporting regulations if it is acting as an agent, a principal that is a dealer or as a Digital Asset Middleman (as described below) with respect to these trades.

An online gaming site may also set up a secondary market platform for trading its own NFTs or third party NFTs (for its players and for non-players). In these cases, if the online gaming platform is not directly acting as an agent or principal that is a dealer with respect to exchanges on these marketplaces, it may still be considered a Digital Asset Middleman with broker reporting obligations for the sales and exchanges. This happens when a person or persons retain sufficient control over the smart contracts utilized on the trading platform to 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. For further discussion of the requirements and issues related to being a Digital Asset Middleman.¹

An online gaming site that would be regarded as a broker will generally be expected to document all of its players and trading market participants for tax purposes, report on sales of digital assets by U.S. or presumed U.S. players/participants to both the IRS and to the players/participants, and conduct backup withholding on proceeds for players/participants who have no (or invalid) documentation and are presumed to be U.S. individuals or other persons that are not exempt from reporting.

What information would online gaming 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 hosted wallets
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)	

¹ See our article “Impact of Proposed U.S. Broker Digital Asset Tax Reporting Regulations on DeFi and Wallet Providers”.

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 products. In addition, if the digital asset was transferred into a hosted account/wallet, then information relating to that transfer will also need to be reported under the proposed regulations.

In certain cases, where a digital asset was 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 as it relates to an online gaming marketplace?

There are numerous operational challenges that the proposed regulations raise with respect to the reporting process, which include the following:

Definition of “digital asset”: A “digital asset” for purposes of the regulations means “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”. One of the challenges for gaming companies will be to analyze the particular token(s) offered on the gaming site to determine whether the token(s) would be classified as digital asset(s) under the proposed regulations. Of particular interest will be tokens that may have limited transferability outside the game, or that can only be utilized and traded within the gaming site.

Issuing digital assets: Under the proposed regulations a minter who is simply creating and selling NFTs is not considered “effecting” a sale as a broker since the minter is not a “dealer”. Arguably, under this rule, broker reporting would not apply to the issuance of digital tokens or NFTs by online gaming companies to players in exchange for cash or other digital assets. A concern has been raised as to whether an online gaming company’s repeated issue of the same digital token may be subject to broker reporting. Moreover, with respect to the issuance of NFTs, additional operational issues arise with respect to co-branded NFTs or NFT drops where the gaming platform is acting as an agent for a third party (also see below).

Broker Redemptions: The proposed regulations treat digital asset issuer redemptions as broker reportable transactions where the online gaming company regularly offers to redeem its digital assets. A marketplace may label as a redemption 1) disabling the digital asset, and 2) a transfer of the digital asset to a wallet with an unusable address (burning of a token). However, the proposed regulations do not define a “redemption”. Further, it is unclear whether the transfer of a digital asset to an unusable wallet by the owner or other similar alternatives would be considered a redemption by the proposed regulations. This will necessitate that a gaming company review potential redemption activity on its platform and make a decision based on available guidance as to whether the activity should fall into the realm of a redemption.

Internal digital asset trading platforms: An online gaming company that maintains an internal trading platform that trades only its own gaming digital tokens will need to assess whether the platform transactions may trigger broker reporting, taking into account whether digital assets are allowed to be transferred outside of the trading platform or are convertible into cash.

Leases of digital assets: Some online gaming sites are considering providing players with the opportunity to lease NFT’s from other players for a fee. Gaming companies should consider the possible impact of the

proposed regulations on the structuring these arrangements. For example, a lease characterized as a financing lease could be treated as a broker reporting sale.

NFT Minting and Drops: The proposed regulations exclude an NFT minter from the scope of a reporting broker. Thus, an individual player, for example, who creates and mints an NFT generally would not be required to report. But if the online gaming company assists the player/minter in selling the NFT, presumably that is a reportable sale. Questions arise where the online gaming company 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 online gaming company and an outside third-party (brand owner). These issues will need to be addressed for those online gaming companies that are selling their own NFTs or issuing their own tokens.

Single Uniform Time Standard Reporting: Proposed regulations apply broker reporting based upon a single Uniform Time Standard for all parties, and this may be operationally difficult to manage for online gaming companies with business units or participants in different time zones.

De minimis transactions: The lack of a de minimis exemption in the proposed regulations can lead not only to a high volume of reportable transactions, but expands significantly the population of users who will need to be documented from a tax perspective.

Cryptocurrency Conversions: If an online gaming marketplace allows a player to convert one digital asset to another (e.g., ETH to MATIC) so that the player 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.

To whom does an online gaming 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 online gaming site can document a player as a non-U.S. person, reporting to that player 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 player if no U.S. indicia is found in that player's profile or, if it is found, the indicia are "cured" by the player providing additional documentation to support its status as a non-U.S. status person.

Finally, if no documentation has been provided by a player or the documentation provided is invalid or has expired, there are presumption rules that would allow an online gaming marketplace/broker to presume the status of the player for reporting purposes. These rules will often presume the player 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 online gaming 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, when NFTs are airdropped to holders of a particular collection and received in a custodial account? 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, or there is a leasing fee paid to an owner of a gameplay NFT 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. players, 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 online gaming 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.

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

There are numerous actions that online gaming sites 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 the online gaming industry segment approach to the regulations and the issues they are seeing, possibly to coordinate feedback on the regulations and as they relate to the online gaming industry.
- 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 online gaming 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.
- Review current contractual arrangements and determine what changes would need to be made to the terms of these agreements in order to comply with these new regulations.

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