Whitepaper

Tokenized securities and other dual classification assets: Special reporting considerations

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The final broker reporting regulations for digital assets, published in the Federal Register on July 9, 2024, added two key terms: dual classification assets and tokenized securities. Brokers must understand and be able to apply special reporting to these types of assets.

In general, a **dual classification asset** is defined as an asset, the sale of which is described in both Treas. Reg. 1.6045-1(a)(9)(i) and (ii) (Treas. Reg. 1.6045-1(c)(8)(i)). The first, Reg. 1.6045-1(a)(9)(i), generally covers the sale or disposition (such as redemptions, retirements and short sales) of a variety of traditional assets such as securities, commodities, options, regulated futures contracts, securities futures contracts or forward contracts. The second, Reg. 1.6045-1(a)(9)(ii), generally covers the sale or disposition of digital assets.

Under the regulations, the general rule is to treat the sales of dual classification assets as sales of **digital assets** under Treas. Reg. 1.6045-1(a)(14)(v) or (vi), **not** as the sale of traditional securities. As a consequence, reportable sales of such assets are reported on Form 1099-DA instead of Form 1099-B.

However, the regulations also provide three notable exceptions to the general rule treating dual classification assets as digital assets. First, dual classification assets that would otherwise be subject to mark-to-market treatment under Sec. 1256 ("1256 contracts") should still be reported under those rules, not as digital assets. (Treas. Reg. 1.6045-1(c)(8)(ii)). Second, dual classification assets that are cleared or settled on a limited-access regulated network are not generally treated as digital assets; these may be covered securities or may not, depending on how they would be treated if they were not also considered digital assets. (Treas. Reg. 1.6045-1(c)(8)(iii)). Finally, dual classification assets that would constitute interests in US Money Market Funds should not generally be treated as digital assets. (Treas. Reg. 1.6045-1(c)(8)(iv)).

There are several important observations that can be drawn from these rules: first, US custodial brokers offering customers digital assets that include dual classification assets constituting 1256 contracts must support both the broker reporting rules of the regulations applicable to digital assets and the reporting rules applicable to 1256 contracts; second, global brokers must carefully distinguish US Money Market Funds from non-US money market funds, as only shares in US Money Market Funds are eligible for the exception referenced above.

Examples of dual classification assets:

- **GoldToken** represents an ownership interest in one gram of gold. It is a dual classification asset if sold for cash because it is both a sale under Reg. 1.6045-1(a)(9)(i) and (ii).
- **MutualFundToken** represents an ownership interest in a US mutual fund taxed as a regulated investment company (RIC). It is also a dual classification asset if sold for cash for the same reason.
- **FuturesToken** represents an ownership interest in a futures contract taxed under Section 1256. It is taxed as 1256 contract under the exception of Reg. 1.6045-1(c)(8)(ii).
- **MoneyMarketFundToken** represents an ownership interest in a RIC that is permitted to hold itself out as a money market fund under Rule 2a-7. It is reported as the sale of a security because of Reg. 1.6045-1(c)(8)(iv).

Tokenized securities are a subset of dual classification assets under the regulations. Tokenized securities either: provide the holder with an interest in another asset that is a security under the general definition in Treas. Reg. 1.6045-1(a)(3), other than securities that are also digital assets; or constitute an asset, the offer and sale of which was registered with the SEC, other than assets treated as securities solely as "investment contracts." (Treas. Reg. 1.6045-1(c)(8)(i)(D)(1)). Traditional securities under Treas. Reg. 1.6045-1(a)(3) generally include stock, trust interests, partnership interests, debt, interests in any of the previously listed, certain options, and securities futures contracts. Notably, qualified stablecoins are excluded from this definition.

Blockchain-traded "mirror" share of Acme Corp., which also trades traditionally on NASDAQ (with its own CUSIP). This constitutes a tokenized security.

Blockchain-traded share of Digital Share Corp., which only trades on the blockchain (but has all the traditional hallmarks of common stock, including voting rights, etc.). This constitutes a tokenized security.

DollarCoin, a stablecoin that passes the regulatory tests to be a QSC (tracks a currency, maintains its peg, used as payment). This is not a tokenized security because it is a QSC (Reg. 1.6045-1(c)(8)(i)(1)(D)(2)).

The regulations provide that tokenized securities remain a subtype of digital assets and are subject to additional reporting. This additional reporting includes providing CUSIP or other identifier information regarding the related security, as well as certain option and debt information. If the tokenized securities are also covered securities, the reporting broker must also include relevant basis and holding period information for wash sales (including in connection with sales between the tokenized security and the related securities occurring within the same account), relevant average basis method adjustments, and option and debt basis adjustments.

This can prove challenging for wash sales analysis. Generally, the wash sales rule should be applied to both the digital asset version of a tokenized security and the discrete, non-tokenized traditional version; as such, an acquisition of one could defer a loss that would otherwise be available from the sale of the other, should the have the same CUSIP. As always, the broker reporting wash sale rules remain narrower than the full wash sales rule a taxpayer must apply.

Similarly, corporate actions can raise additional challenges. Currently, under the digital asset regulations there is no requirement forcing a broker to adjust the basis of a tokenized security due to a corporate action on the underlying traditional security other than pursuant to an issuer statement. While Treas. Reg. 1.6045-1(d)(6)(i) implies that a broker could take such third party information about events into account for the digital tokenized security, it does not seem to require the same. Reliance on information not provided by an issuer statement could potentially result in penalty risk, which seems problematic given the challenges in even identifying the issuer of many digital securities.

There are also open questions regarding basis adjustments that might apply to a tokenized security due to transformative events that affect the basis of the related stock or security (such as a merger or distribution affecting basis that are often referred to as types of "corporate actions"). First, the regulations do not explicitly require brokers to make such adjustments for tokenized securities constituting covered securities. Second, it is uncertain who the issuer of the tokenized security is for purposes of reporting corporate actions affecting the basis of specified securities under IRC Sec. 6045B. If it is the issuer of the token, then it must be determined whether such issuer should report applicable adjustments reported by the issuer of the related security. Finally, a broker that considers making basis adjustments to tokenized securities must consider potential penalty risks under Reg. Sec. 1.6045-1(d)(2)(iv)(B), since brokers are not able to rely on penalty relief related to reliance on information provided by third parties for digital assets.

Thus, tokenized securities result in both additional reporting and computational challenges for brokers, as well as potential reporting considerations for issuers of such securities.

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