November 13, 2023

Via Electronic Upload

Scott W. Vance, Associate Chief Counsel (Income Tax and Accounting)
Office of the Associate Chief Counsel (Income Tax and Accounting)
Internal Revenue Service
CC:PA:LPD:PR (REG–122793–19) Room 5203
P.O. Box 7604, Ben Franklin Station
Washington, DC 20044

RE: IRS Proposed Rulemaking REG–122793–19; Gross Proceeds and Basis Reporting by Brokers and Determination of Amount Realized and Basis for Digital Asset Transactions ("Proposed Regulations")

Dear Associate Chief Counsel Vance:

Hedera Hashgraph, LLC (the members of which are collectively known as the "Hedera Council") is the multi-stakeholder governing body of the Hedera Network; an open source, proof-of-stake public distributed ledger (also known as a "Layer 1" protocol or "blockchain"). The Hedera Council is a coalition currently comprised of twenty-nine (29) independent and unaffiliated member companies and universities who operate and govern the Hedera Network.[1] Given the inherent absence of a central intermediary to process payments between the operators and users of the protocol, the Hedera Network relies upon a network-specific digital asset ("hbar") that users utilize to make micropayments every time they consume a Hedera Network service, i.e., whenever their application utilizes the protocol to invoke a service from the Hedera Network Application Programming Interface (Hedera API or "HAPI"). This micropayment is then algorithmically distributed as a peer-to-peer payment to the participants who collectively maintain the network by operating network nodes or by staking their hbar balance to trusted network node operators as a crowd-sourced security mechanism.

We are pleased to submit these comments regarding the IRS proposed rulemaking, Gross Proceeds and Basis Reporting by Brokers and Determination of Amount Realized and Basis for Digital Asset Transactions ("proposed regulations"), concerning the definition of broker and reporting for digital asset transactions in an effort to assist the agency by offering six constructive recommendations that mitigate the risk of unintended consequences inherent in the existing language.

[1] https://hedera.com/how-it-works

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1) **The regulations should more clearly exempt Layer 1 blockchain infrastructure from the definition of broker.** The proposed regulations acknowledge the integral role that certain participants in blockchain infrastructure play and rightly attempts to exempt them from the definition of "facilitative services," and therefore from the definition of "broker," individuals or entities who are "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." However, as described below, this exemption is too narrow and thus creates ambiguity for individuals and entities who are not operating as "middlemen."

2) **The regulations should exclude the fee-for-service system of Layer 1 blockchains from the definition of facilitative services**. The proposed regulations include a definition of broker that indicates "a person that regularly offers to redeem digital assets that were created or issued by that person," but they do not offer a definition of "redeem" or "redemption" in the context of digital assets, creating risk of uncertainty for prospective network participants who are unsure if their role in the network might under those terms. Such uncertainty would unnecessarily slow market adoption of these innovations by non-broker participants such as node operators. Many individuals and entities are involved in maintaining public ledger networks that do not fall within the activities the IRS is attempting to regulate with these new rules, e.g. network stakers and node operators are essential network participants in Layer 1 blockchains who do not "redeem" digital assets in our understanding of that term, but it is unclear if their activities might fall under the undefined terms in this regulation. The proposed regulations should offer clear definitions about what is, and is not, included in the meaning of redemption in the context of digital assets and especially Layer 1 blockchains.

3) **The regulations should clearly note that message processing and validation, including all of its component steps, are not equivalent to an issuer redeeming its native currency.** Services are built on top of the Layer 1 Hedera Network, such as smart contracts, tokenized assets, and web3 applications. Layer 1 networks offer a variety of functional services in exchange for user micropayments that utilize the network's native digital asset. For example, users of the Hedera Network's most popular feature, the Hedera Consensus Service, can pay the network in the network's native digital asset, hbar, to sort and time-stamp messages submitted to the network that contain additional information that is encrypted and only readable by the submitting party. This service allows, for example, accurate tracking of supply chains with cryptographic proof of when certain events took place. The regulations should make clear that these types of services are excluded from the meaning of 'redeem' or 'redemption.'

4) **The regulations should expand the definition of facilitative services beyond activities for 'validating distributed ledger transactions' to include key components of what is necessary to securely operate a proof-of-stake distributed ledger.** The security mechanism being piloted on the Hedera Network relies in part on individual users staking their hbars to specific nodes on the network, depending on that user's trust of the node. The act of staking itself requires the use of a wallet (as described below), and the network algorithm

determines how much weight in consensus “voting” to give a particular node based on how many hbars users have staked to that particular node, within parameters fixed by the open source software running on the network nodes. This activity is necessary to derive the correct order of API service requests submitted to the network regardless of which node received the initial transaction request. The proposed regulations should clearly exclude all aspects of operational staking activity from the definition of ‘facilitative services.’

5) **The regulations should exclude staking through a proof-of-stake network from the definition of facilitative services, as it is essential to proof-of-stake network security.** Staking helps determine network node reliability and in exchange for this crowd-sourced security mechanism, the Hedera Network incentivizes stakers in the form of a small reward payment calculated as a percentage of a user’s staked hbar, should that user choose to accept such rewards. This security mechanism, utilized by all proof-of-stake networks, should be clearly excluded from the definition of facilitative services because it is not the type of activity the new regulations seeks to regulate, and leaving the scope of “facilitative services” vague will have the unintended consequence of undermining the security of distributed public ledgers that utilize this mechanism.

6) **The regulations should exclude unhosted wallet software from the definition of facilitative services.** Unhosted (self-managed) wallet software is designed to ensure the user of distributed public ledger services remains in full control and possession of “the keys” that are required to initiate transactions on behalf of their account on the public ledger, and therefore, full control over the digital assets they have in such accounts. Unlike hosted wallet software developers (such as exchanges and other custody providers), the unhosted wallet software developers have no visibility into how their software is used once it is released into the market. They do not know what transactions or connections the user of their wallet software will initiate. Unhosted wallets are the “user agent” tool through which many users interact with public ledger networks to perform a variety of functions, in the same way a web browser is the “user agent” most people interact with to initiate various web applications. The regulations should exclude unhosted wallet software from the definition of facilitative services in order to avoid the unintended consequence of preventing Americans from benefiting from best-in-class security features only available through unhosted wallets.

In conclusion, we welcome the opportunity for further dialogue regarding tax reporting for digital asset transactions.

Sincerely,

/e-signature/

Brett McDowell
President & Chair
Hedera Hashgraph, LLC