Final IRS Regulations Implementing Tax Reporting Requirements for Brokers of Digital Assets

Snapshot Overview On December 27, 2024, Treasury and IRS finalized a rule that requires certain providers of front-end services, i.e., software applications that provide a convenient but non-exclusive means for users to interact with decentralized (DeFi) trading protocols, to comply with broker tax reporting requirements (the "Final Rule"). The Final Rule demonstrates a fundamental misunderstanding of how DeFi provides significant value to Americans and would end DeFi innovation in the U.S., moving many if not most DeFi companies, developers, and the industry-at-large to other jurisdictions at the expense of Americans and the American economy. For the following reasons, we support a joint Congressional Review Act (CRA) resolution to overturn the Final Rule: (1) the Final Rule violates the Administrative Procedure Act (APA) because it exceeds Treasury's authority under the Infrastructure Investment and Jobs Act (Infrastructure Act); (2) it violates the Fourth Amendment's protections against unlawful searches and seizures and has the improper effect of converting DeFi into covered financial institutions under the Bank Secrecy Act (BSA) without Congressional authorization; and (3) it attempts to treat DeFi services in the same manner as ordinary intermediated broker services for securities despite the lack of intermediaries, which is not feasible nor reasonable and vitiates the significant benefits that DeFi provides to American citizens.

Background Congress authorized the IRS to request information returns from "brokers" on "Form 1099." More specifically, brokers who "effect" sales for customers are required to provide their customers and the IRS with relevant information about the sales. In 2021, Congress considered legislation to amend the definition of "broker" to reflect certain parties in the blockchain industry (S. 4751). While Congress did not move forward with that legislation, language was included in the Infrastructure Act, which expanded the definition of broker to include "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person."[1] In August 2023, the IRS proposed rules for implementing tax reporting requirements for digital asset brokers. In July 2024, the IRS published the final version of the *Gross Proceeds and Basis Reporting by Brokers and Determination of Amount Realized and Basis for Digital Asset Transactions* ("July 2024 Regulations") focused on custodial digital asset brokers (e.g., centralized exchanges). The IRS announced they would issue separate final regulations describing information reporting rules for non-custodial industry participants (e.g., DeFi trading front-end service providers).[2] That Final Rule was released on December 27th, 2024.

Overview of the Final Rule

Treasury and the IRS determined that it will treat DeFi participants that provide "front-end trading services" as "brokers." The Final Rule's broad definition of "trading front-end services" sweeps in, among others, providers of software tools and websites, despite the fact that such services do not function like traditional brokers: DeFi applications do not take custody of assets, communicate actual transaction orders to custodians, have account or customer relationships with users, or many other activities that are generally associated with traditional brokers. The Final Rule ignores these significant differences between DeFi and traditional brokers.

[1] 26 U.S.C. §6045 (c)(1)(D)

[2] Treasury declined to finalize rules "that apply to non-custodial industry participants," as Treasury would "continue to study th[e] area." 89 Fed. Reg. 56, 480, 456, 492 (July 9, 2024).

Administrative Procedure Act

The Final Rule's expansion of who constitutes a "broker" goes beyond Congressional intent as expressed in the Infrastructure Act, which defines a broker as "*any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.*" As described in the numerous comment letters that responded to the proposed broker regulations, in general, DeFi applications do ***not*** effectuate digital asset transactions, instead they merely provide a convenient tool for users to effectuate transactions themselves. Since the software does not actually undertake the activity of effectuating the sale—instead simply helping individuals consummate their own transactions—it is not appropriate to expand the broker definition to these persons.

Congress never intended for Treasury to take an expansive approach in regard to the term "broker." After passing the Infrastructure Act, Senators Warner, Portman, Sinema, Toomey, and Lummis wrote to Treasury stating that "[t]he purpose of this provision is ***not*** to impose new reporting requirements on people who do not meet the definition of brokers." In addition, Treasury indicated that it would avoid an overly broad definition of the term "broker" in a prior letter to the Senate from U.S. Treasury Assistant Secretary for Legislative Affairs, Jonathan C. Davidson, which stated that "[c]onsideration of regulations in the notice of proposed rulemaking will be based on principles broadly similar to those applicable under current law for broker reporting on securities transactions." Nonetheless, the Final Rule explicitly described it as "a new category of broker." This "new category" of broker and proceeding reporting requirements will have expansive and onerous implications for the DeFi industry and those who participate in it. Despite a few general examples provided, the application of the definition of a "front-end service provider" remains vague and most DeFi web apps (particularly those with a "connect wallet" feature) are likely to be covered, including websites, unhosted wallets, and browser extensions that allow users to swap digital assets through their interface.

Fourth Amendment and Bank Secrecy Act

The Final Rule would require certain third parties to transmit private information about individuals to the government. As written, this requirement could violate the Fourth Amendment's protections against unlawful searches and seizures. While the Fourth Amendment has largely been relegated to criminal cases, the novelties of blockchain technologies—as well as the government's proposals for regulating them—suggest that the Fourth Amendment could be an important limiting factor with respect to the Final Rule, especially in regards to the private information of DeFi users.

In addition, the Final Rule would have the improper effect of converting DeFi applications into covered "financial institutions" under the BSA without Congressional authorization. As a general matter, in the context of crypto, the BSA comes up often in the context of a subtype of financial institution known as a "money transmitter," which has been interpreted to capture entities or persons that have control or possession over a user's assets. The BSA requires money transmitters, like all other financial institutions, to collect Know-Your-Customer (KYC) information and to implement effective anti-money laundering programs. The Final Rule would create similar personal identifying information (PII) collection and transaction reporting requirements for DeFi applications, even though Congress has never passed legislation that would classify them as financial institutions under the BSA.

The Benefits of DeFi

Blockchains allow companies to reimagine traditional market structures. In traditional markets, there tend to be various centralized intermediaries that facilitate exchange, custody assets, and clear and settle transactions. All of these centralized intermediaries charge fees, introduce delays, and give rise to significant third party risks. Blockchains are autonomous software that enable users to transact securely without the costs imposed by intermediaries, custody their own assets, and benefit from nearly instantaneous settlement. If tax authorities required front-end interfaces to comply with traditional broker reporting requirements, it would force them to shed the technological benefits that blockchains provide, adopt traditional legacy business models, and pass along those associated costs, to the significant detriment of users.

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The long term implications of this rule include restricting the ability of Americans to execute their own digital asset transactions, prohibiting software developers from building transaction features for non-custodial wallets, and ultimately limiting Americans' access to DeFi platforms. In aggregate, this will severely stunt this important area of technology and software development. For these and other reasons, CCI supports Senator Cruz's CRA that would repeal this rule, leaving reporting responsibility with the categories of brokers that clearly act as either custodians or agents of their customers—in line with the original intent of Congress and the ordinary understanding of broker services.