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IRS Broker Rule for Digital Assets Faces Constitutional Challenge From Industry Leaders

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Three digital asset organizations have jointly filed a lawsuit challenging the Internal Revenue Service's (IRS) new digital asset broker reporting rule.[1] The complaint, filed in the Northern District of Texas on December 27, the same day the IRS issued the final rule, alleges that the rule not only exceeds the IRS's statutory authority but also violates the Fourth and Fifth Amendments of the Constitution.[2]

The new IRS rule requires "digital asset middlemen" to collect and report detailed transaction information to the IRS. The plaintiffs argue that this requirement fundamentally misunderstands the decentralized nature of decentralized finance (DeFi) technology and would effectively force the creation of intermediaries where none currently exist — a move that could devastate the US DeFi industry.

Statutory Authority and Rulemaking Challenges

The complaint's primary argument centers on alleged violations of the Administrative Procedure Act. At issue is the IRS's interpretation of "broker" under Section 6045 of the Internal Revenue Code. In 2021, the Infrastructure Investment and Jobs Act amended Section 6045 to define "brokers" specifically as entities that "effectuate transfers of digital assets."[3] According to the complaint, during the legislative process, Congress explicitly considered and rejected broader language that would have captured decentralized exchanges and peer-to-peer marketplaces. Despite this legislative history, the IRS rule extends the definition to encompass entities providing "facilitative services" or "trading front-end services." The plaintiffs argue this expansion contradicts Congress's intent and exceeds the IRS's statutory authority.

The complaint also asserts the IRS failed to engage in reasoned decision-making by inadequately considering thousands of substantive public comments during the rulemaking process. These comments detailed how the proposed rule would significantly and negatively impact the US DeFi industry.

Constitutional Challenges

The lawsuit presents two distinct constitutional arguments. First, it alleges Fourth Amendment violations, arguing the rule's information collection requirements constitute warrantless searches of both transaction participants and reporting entities. The plaintiffs contend that users of DeFi protocols have not voluntarily conveyed their personal information to these entities, making the mandatory collection of such data constitutionally problematic.

The Fifth Amendment challenge focuses on the rule's alleged vagueness. The plaintiffs argue the definitions are so broad and unclear that affected parties cannot reasonably determine whether they must comply with the reporting requirements, violating due process principles.

Practical Implementation Concerns

The practical implications of the rule raise substantial concerns about feasibility and proportionality. According to IRS estimates cited in the complaint, the rule would generate approximately 8 billion new information returns annually, requiring about 4 billion hours of compliance work. The estimated annual compliance cost could reach $260 billion — a figure that appears disproportionate to the estimated $10 billion tax gap the rule aims to address.

Many DeFi protocols operate through smart contracts that execute transactions automatically without traditional intermediaries. The plaintiffs argue that requiring facilitative or trading front-end services to collect and report user information would necessitate fundamental changes to their technological architecture, undermining DeFi's core innovation of trustless, disintermediated blockchain transactions.

Industry Impact

The lawsuit highlights the fundamental tension between traditional financial reporting frameworks and DeFi's core technological innovation: the ability to execute financial transactions without intermediaries through self-executing smart contracts on public blockchains. The IRS rule attempts to retrofit intermediary-based reporting requirements onto a system specifically designed to eliminate intermediaries through cryptographic verification and distributed consensus mechanisms. As the court considers this challenge, it must grapple with whether administrative agencies can effectively mandate the insertion of intermediaries into a technological architecture built precisely to operate without them.

[1] Gross Proceeds Reporting by Brokers that Regularly Provide Services Effectuating Digital Asset Sales, 89 Fed. Reg. 12,345 (Dec. 30, 2024) (to be codified at 26 C.F.R. pt. 1).

[2] *Blockchain Ass'n et al. v. IRS*, No. 3:24-cv-03259-X, (N.D. Tex. filed Dec. 27, 2024).

[3] 26 U.S.C. § 6045(c)(1)(D).

> "That all will have been the result of a rule that is both unlawful and unconstitutional. It is unlawful in violation of the Administrative Procedure Act . . . because it exceeds Treasury's authority by rewriting the statute Congress wrote. That statute authorizes the IRS to require reporting from entities who 'effectuat[e] transfers of digital assets,' but DeFi's innovation is that users effectuate their own transactions with each other."

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