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How Virtual Decentralized Entities May Obtain Tax-Exempt Status

By Rustin Diehl
Allegis Law

Decentralized autonomous organizations that have a nonprofit or charitable purpose and accordingly seek tax-exempt status must navigate a bizarre and incongruent tax regime, says Rustin Diehl of Allegis Law.

Not-for-profit and charitable decentralized autonomous organizations may seek to be exempt for federal tax purposes but, as with DAOs generally, the IRS has not particularly addressed the taxation of these DAOs as digital age entities.

Ultimately, the lack of profit or loss sharing and the activities of some DAOs may not cause default into partnership or any other entity status. A joint undertaking the activities of which do not give rise to a separate taxable entity is denoted by the diminutive adjective "mere" in the Treasury regulations underlying the partnership code—for example, in Reg. §301.7701-1(a)(2), "merely to share expenses does not create a separate entity for federal tax purposes." In some situations, a DAO conducting a joint undertaking may need to apply for tax exemption. The bivariate classifications of DAOs as for-profit and nonprofit simply fail to capture the operational facets of many DAO social enterprises or even protocol holding DAOs. This gives rise to many theoretical possibilities for a DAO to carry out social entrepreneurship and charitable activities through nontraditional structures are legion. For example, a not-for-profit or charitable DAO might be organized: (1) as an informal alliance of individuals merely holding property, (2) as a purpose trust supporting a cause of class of beneficiaries, or (3) under a formal exemption determination letter.

DAOs as 'Mere Co-Ownership' of Property Not Classified as Entities

Rather than carrying on a business for profit, as anticipated with a traditional enterprise, a nonprofit or charitable DAO is organized primarily to conduct public benefit ventures from which neither the DAO nor its token holders will derive any profits from the labors of others—for example, some DAOs hold protocols for use by consortiums of individuals or companies. Other charitable DAOs incentivize independent entities or people to provide charitable support services, and some pool resources for passive grants to charitable activities. The use of the tokens for charitable purposes could be seen as lacking a profit motive, making the imposition of a deemed for-profit business status inappropriate.

An organization may opt out of the default partnership status at the "election of all the members of an unincorporated organization, if it is availed of… for the joint use of property," according to the partnership definition in §761. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

Under the "mere co-ownership" exception to entity taxation, the activities underlying some value storage cryptocurrencies like Bitcoin are unlikely to rise to the requisite level of common enterprise for classification as any type of entity, primarily because investors are merely looking for profits from the change of value in bitcoin and not carrying out a business or operation. The late Professor Emeritus David J. Shakow, in a 2018 Tax Notes article, *The Tao of the DAO: Taxing an Entity That Lives on a Blockchain* (heretofore "Shakow"), posited that "[p]ure cryptocurrencies, like bitcoin, are based on a blockchain structure, but they do not reflect an ownership interest in any entity." (Bitcoin blockchain is not organized as a DAO to carry out enterprises.) Similarly, some blockchain-based DAOs may exist for the narrow purpose of merely holding joint property, for public benefit purposes without conducting profit-seeking activities that might give rise to a taxable entity.

DAOs are designed to operate in a decentralized, democratic, and transparent manner, with decision-making power distributed among its members. While many DAOs are created with the goal of generating profits for their members, some are for nonprofit or public-benefit purposes. (*See generally* Primavera De Filippi and Aaron

Wright, *Blockchain and the Law: The Rule of Code* (OpenAI GPT-3 version 2.2, 2021).) For example, the Giveth decentralized charitable platform allows people to donate to various charitable causes; MyBit DAO supports the development of the Internet of Things by funding IoT-related projects; MolochDAO funds important Ethereum projects; MetaCartel DAO supports the development of Ethereum-based products and services; and MakerDAO operates the Maker Protocol, which allows users to create a stablecoin called DAI that is pegged to the US dollar. While these DAOs may not have the primary goal of generating profits, they may still engage in activities that generate revenue. Additionally, the tax implications of participating in a non-profit DAO may depend on the DAO's specific structure and activities as well as the tax laws of the jurisdiction in which it operates.

Despite the Internal Revenue Code's non-deference to uniform law, assigning non-entity tax status for co-ownership arrangements that lack profit and loss sharing would be consistent with the uniform law for partnerships. Rev. Rul. 144, 1953-2 C.B. 212. The Revised Uniform Partnership Law (1997) provides at §202(c) that "[t]he mere co-ownership of property through joint tenancy, tenancy in common, tenancy by the entirety, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made from the use of that property. The sharing of gross returns from a property does not by itself establish a partnership, even if the persons sharing those returns have a joint or common right or interest in property from which the returns are derived."

Default to Trust Entity Status?

DAOs abide in a tight tension between the treatment of a DAO as a participative partnership sharing profit and loss, versus an arrangement for mere co-ownership of property, as opposed to an arrangement for property protection and conservation vested in a third party. In an instance where the owners in what might otherwise be a mere co-ownership arrangement, voluntarily relinquish control over the property by vesting legal rights to protect and conserve the co-owned property in a third party to make decisions, even where the owners maintain equitable rights to distributions of/from the property, it is also necessary to consider whether a DAO holding property might give rise to a resulting trust at the behest of the DAO members, or constructive trust by order of a tax court.

Whereas for-profit DAOs generally will be deemed partnerships, the default tax classification assigned to multiple individuals carrying on profit-seeking activities (Reg. §301.7701-3(b)(1)(i)), Reg. §301.7701-4(a) provides a general rule that trust treatment may apply depending on "[whether] it can be shown that the purpose of the arrangement is to vest in *trustees* responsibility for [charitable purposes] for beneficiaries who cannot share in the discharge of this responsibility" (emphasis added).

However, a DAO might not easily qualify as a trust, because the centralization of authority in a trustee does not exist in a DAO, which instead distributes decision-making responsibility to token holders. Simply put, in the pure organization of a DAO, as conceived by the creators, there are no trustee-like fiduciaries with plenary responsibility for the activities; control and the discharge of responsibility resides in a majority decision of the crowd rather than in the hands of a trustee. The lack of centralized authority would either cause the DAO to fail the test for qualification as a trust or demand a significant adaptation of the trust terms to make it suitable for use with the DAO structure.

Notwithstanding these challenges, where the governing board or managers of a DAO have plenary decision-making responsibility, the DAO might be deemed to have the functional equivalent of "trustees tak[ing] title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts." *Id.* Some DAOs may unintentionally or intentionally choose to vest authority in a board or other management over key decisions such as filing taxes and complying with regulations. Online retailer Overstock, albeit not a DAO, set up a subsidiary corporation for compliance reasons. In a board-vested DAO, the widespread DAO members might merely advise the board by voting on non-binding resolutions, but contractually cannot share in the discharge of the responsibilities. The Uniform Directed Trust Act (UDTA) provides that such persons would be termed "trust directors."

Where the smart contracts give authority to a board holding plenary authority over protection and conservation of property, this vesting of authority could cause default into trust taxation under the same regulations which provide general default taxation to the partnership tax rules.

Reg. §301.7701-4(a) also mandates that an arrangement "[will] be treated as a trust under the Internal Revenue Code," [if] "the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit." The default to trust tax treatment is without regard to whether the trust was set up by another person for the beneficiary, or whether it was "self-settled." While Reg. §301.7701-4(a) exempts self-settled trusts, control of the property again becomes the focal issue, as the subsection goes on to provide: "However, the beneficiaries of such a trust may be the persons who create it and it will be

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recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them."

The default tax treatment of a DAO as a trust could be quite unfavorable from an income tax perspective due to the generally higher income tax rates applicable to trusts. The DAO would also face significant capital gains income tax consequences and compliance burdens under the uniform trust basis rules. Finally, treatment as a trust would necessitate that a DAO fulfill diverse compliance and reporting requirements pertinent to gift, estate and transfer tax reporting, on the expressly named trustees or the person(s) constructively deemed to be trustees, who are vested with the discharge and responsibilities to protect and maintain DAO property.

However, just as some larger partnerships fall under Publicly Traded Partnership rules and are taxed as corporations, some trusts that carry on profit-seeking enterprises will be classified for taxation purposes as business trusts or commercial trusts, pursuant to Reg. §301.7701-4(b) provid[ing] that there are other arrangements known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but that are not classified as trusts for federal tax purposes because they are not simply arrangements to protect or conserve the property for the beneficiaries. But such a trust may be treated as a business entity, the subsection goes on to provide, as "[t]he fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if the organization is more properly classified as a business entity under §301.7701-2." This secondary pour-over by default to the partnership or corporate tax rules of an entity deemed to be a trust for tax purposes is contingent on the crux issue of whether a trust is for the protection and conservation of property, rather than used "simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code…" *Id.*

It is somewhat murky and dependent on circumstances to decide whether a trust is a business trust or commercial trust, and therefore taxed as a business entity, due to the potentially passive nature of investments. In what would otherwise be taxed as a trust arrangement, if the investments are actively managed under, pursuant to Reg. §301.7701-4(c)(1), a "power to vary the investment of the certificate holders," the trust will be deemed an "investment trust" and treated as a partnership or corporation.

The discharge of minimum of DAO investment decisions by DAO members making decisions over the investments may be substantial enough to implicate tax treatment as a profit-making business, rather than the default trust tax laws. However, as happened with the original DAO, "THE DAO," incongruity between tax laws and security laws may still permit the SEC to find that the investment activities of the DAO members do not adequately require the participation of the DAO members to avoid classification as a passive investment under securities laws.

Although the mere holding of property is insufficient to impose business taxation on a DAO, by using the property to providing services, whether for profit, or not for profit, a DAO will be shoehorned into some sort of taxable entity status. Whether producing income under a trust, partnership, or corporation, for state entity formation and federal tax purposes, any of these potential entity statuses implicate diverse tax consequences to a DAO. However, with anti-establishment roots stemming from the world of cryptocurrencies, many DAOs eschew the imposition of centralized command, control, and personal responsibility. These DAO aspire for democratic rule of the crowd so that no one person would answer for the DAO's actions. Some of these DAOs would take a ruggedly subversive and anarchic stance toward subjection under any entity taxation status, holding themselves as nonprofit autonomous organizations.

Exemption Options

Charitable DAOs that wish to both (a) conduct tax-exempt economic activities and (b) qualify donations for tax deduction must carry on their activities under the auspices of an entity that has been granted tax-exempt status by the IRS. The I.R.C. is designed to include accountability by requiring that tax deductible charitable contributions may only be donated to US government units; §501(c)(3) tax-exempt organizations; posts or organizations of US war veterans; domestic fraternal societies, orders, or associations operating under the lodge system; and cemeteries. Apart from the cemeteries, it is nearly always required that the charitable gift be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. Further, organizations granted tax-exempt status must put forward a living, breathing human being with a hand to shake (or throat to choke) to answer on behalf of the organization's charitable activities.

So, what is the workaround for nimble DAOs wanting to conduct philanthropy and avoid the heavy-handed tax-exemption requirements? The short answer is that under current laws, there isn't one, but note that a DAO with very low annual gross receipts (under $5,000) could qualify as a nonprofit under the §501(c)(3) gross receipts test.

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And for the true-blooded crypto anarchist who sees the requirements of centralized human-based organization as an affront to their ideology, there are many alternatives that could enable a charitable DAO to conduct philanthropic activities with lighter burdens than full tax exemption.

Depending on the intended activities, a charitable DAO could apply to be tax exempt as a:

- Private foundation under §501(c)(3);
- Public charitable organization under §501(c)(3);
- Support organization under §509(a)(3) or a feeder organization under §502;
- Social welfare organization under §501(c)(4);
- Business league or trade organization under §501(c)(6); or
- Social club under §501(c)(7).

The charitable DAO needs to first organize as a corporation or trust at the state level and then submit its application to the IRS. Under §508(a), the charitable DAO needs to file IRS Form 1023, the application for the §501(c)(3) exemption. As discussed earlier, for a DAO, the imperative to organize as an entity and the tax rules premised upon this requirement pose unique challenges to the heterodox operational and nontraditional organizational structure of a DAO. Note that an LLC wholly owned by a single exempt organization can also qualify for tax exemption as provided by Announcement 99-102.

While being able to operate tax free and provide a tax deduction to donors for their donations is a decisive advantage for a charitable DAO, it must exercise caution not to trip over the many strings attached to the exemption. A particular consideration is whether the fundamental governance structure of a DAO would impermissibly vest control in the token holders, who could effectively vote to "hard fork" the nonprofit company to for-profit status. Constraints against the majoritarian control features of a DAO would be needed or else it could easily violate one of the many laws applicable to charities and risk revocation of its tax exemption. A nonprofit DAO will need a governance structure that disallows such an activity through board control as laid out above in the discussion on corporate DAO structures.

It is important to note that still other DAOs will be operated as hybrid for-profit enterprises with a corporate social responsibility program (CSR), or perhaps organized as a Benefit Corporation, Benefit Limited Liability Company, Low-Profit LLC (L3C) and Flexible Purpose Corporation (FPC). The tradeoffs between these hybrid organizational options will revolve around the formalities required or imposed on the DAO, as well as whether the activities of the DAO must somewhere involve a tax-exempt organization, and whether charitable deductions are permitted to the donors for the charitable contributions they make through the DAO or out of the DAO tokens they own.

Conclusion

With DAO capitalization exceeding US$45 billion, state and local, as well as federal and international jurisprudence, legislature, regulation, and institutional infrastructure are growing. The globally incumbent institutional, legal, and regulatory infrastructure all saddle DAOs, particularly ones that have a charitable purpose and accordingly seek tax-exempt status, with a bizarre and incongruent tax regime, based on imported assumptions concerning entities and misunderstandings of the nature of DAOs. The current flourishing of decentralized autonomous organizations makes it incumbent upon government instrumentalities to innovate their tax infrastructures. In our digital age, charitable DAOs may well complement their "real" counterparts serving philanthropic purposes, even pose a competitive advantage, in many incremental and perhaps radical ways to jurisdictions that facilitate their activities.

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Author Information

Rustin Diehl practices law in the areas of taxation, estate, and business planning with Allegis Law. He advises individuals and businesses on a variety of issues relating to Web3 and blockchain, federal and state tax planning, and tax controversy, and has formed numerous trusts, DAOs, and LLCs for digital asset holding and trading.

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