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# Virtual Decentralized Entity Taxation Needs Real Development

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*Now that decentralized autonomous organizations have undergone significant capitalization and proliferation, it is necessary to consider at greater length the entity-level tax implications arising from the ways in which DAOs carry on activities—and the tax regime and guidance need to be further developed accordingly, says Rustin Diehl of Allegis Law.*

Disconcertingly for founders of decentralized autonomous organizations, the IRS has not particularly addressed the taxation of DAOs as digital age entities, leaving them to default into analog partnership status or to rely on check-the-box rules. In both instances, the requirements pertaining to compliance are a point of centralization. At the time of writing, token transactions have been the subject of IRS guidance, none of it discussing the tax treatment of DAOs as taxpayers. Consequently, many DAOs are arguably tax hybrids, with Schrodinger cat-like superposition in several tax entity characterizations.

A DAO seeking certainty as to its tax status might affirmatively elect to be taxed as an entity on Form 8832, *Entity Classification Election.* A DAO that chooses to organize as a partnership or corporation under local law, or elects to be taxed as a partnership or association taxable as a corporation under the check-the-box regulations, will usually be recognized by these affirmative filings, according to the general rule of Reg. §301.7701-2(b)(1). However, by and large, DAOs are maintaining an uncomfortable silence on their status as entities for both liability and taxation purposes. Failure to make an election concerning a DAO's tax status would leave the tax classification of a DAO to be determined under the default internal revenue code provisions, treasury regulations, and sub-regulatory guidance, as well as case law. 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"), points out the incongruity in the treatment of the first DAO ("THE DAO") as a passive investment for SEC security classification purposes, while the very same DAO might simultaneously be deemed a participative partnership for taxation purposes.

### *Determining DAO Entity Status for Tax Purposes Is Complex*

Notwithstanding the uncertain tax treatment of DAOs, the white papers for the many early DAOs focus entirely on technical architecture and economics (often called tokenomics) of the DAOs, also avoiding discussion of their status as legal entities. However, the MakerDAO white paper does provide in footnote 1: "Note that Decentralized Autonomous Organizations, or DAOs, are understood in the Ethereum community as largely social and technical communities centered around a particular mission or project, and does not necessarily imply the existence of traditional corporate forms." A few of the earlier small DAOs provided cursory discussion on legal organizations in their white papers or private placement memoranda, and a few US-based traditional companies subject to pre-existing regulatory oversight have tokenized their securities onto the blockchain by funding them into a separate juridical entity (not DAOs) and overlaying the securities with corporate chassis as a tax blocking structure.

Adding to the DAO tax entity classification problem, despite the rising prominence of DAOs and the paucity of rules or regulatory guidance on their status as taxable entities, relatively few tax professionals have dared tread into the space of DAOs to publish concerning the appropriate taxation of this nascent species of organization. However, Shakow provided an outline of high-level entity taxation issues relevant to the failed launch of the first DAO.

Following a narrative of THE DAO's ultimate failure, Shakow raises the issue that a DAO might be classified as a tax entity, even though a DAO is a "disembodied creation floating in cyber space, with no apparent form." Biyan Meinart explains in *How can a decentralized autonomous organization (DAO) be legally structured?* (2021) that, being based in a decentralized blockchain network, a DAO is fundamentally opposed to a "search for a cartographic center, since no special center of gravity can be determined," and so the principle of Lex Loci Rei Sitae (law of the place where the property is situated) cannot be implemented (p. 4). While the Lex

Fori principle could be used to apply the positive law of the state, nation, or jurisdiction in which the lawsuit is instituted, seeking remedy under this may prove impractical where multiple jurisdictions are implicated (*id.*).

Under Reg. §301.7701-1(a)(1) and (2), notwithstanding the fact that a DAO is not organized as an entity under local law, it may still "create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom."

Now that DAOs have undergone significant capitalization and proliferation, it is necessary to consider and develop at greater length the entity-level tax implications arising from the fundamental ways in which DAOs might (or might not) carry on activities and participants might (or might not) participate in them.

DAOs permit organizational forms that maximally decentralize the production or consumption activities and aim to provide bottom-up, self-organized approach to organizational control and governance functions, reducing collusion by bridging the chasm between management and ownership. The uses and activities of DAOs can be broken down into some general categories— (1) charitable and social purpose (nonprofit), (2) shared property and collections, (3) investment, and (4) governance or protocols—based on the decision flow provided by Chris Brummer and Rodrigo Seira in *Legal Wrappers and DAOs*, Social Science Research Network, at 30 (May 30, 2022). Their decision flow primarily considers (1) liability potential for off-chain activities or disputes (2) tax advantages of incorporation depending on non-profit or for-profit activities, and (3) centralization. *See also* Bud Hennekes, *The 8 Most Important Types of DAOs You Need to Know*, Alchemy (Apr. 6, 2022).

A review of prominent DAOs turns up a mix of DAOs carrying on activities for profit (e.g., MakerDAO, Curve DAO, Uniswap, Compound), DAOs purporting to merely hold property (often in fractionalized form) for the benefit of the DAO participants (Aragon Court, MolochDAO, DxDAO, Gnosis Safe Multisig, PieDAO, ConstitutionDAO), and/or DAOs conducting activities or creating environments for various societal benefits (GitcoinDAO, Commons Stack, KlimaDAO, DXdao, MetaCartel DAO). Some of these DAOs may attempt to fulfill several of these purposes simultaneously, and might not fit tidily into any of the existing IRS rules for tax classification.

Creators of DAOs should be wary that by failing to formally organize the DAO and expressly make a tax election, the DAO might have any of several default tax statuses imposed upon it.

### *First Default Classification Is Partnership*

Many DAOs will be deemed partnerships, the general default tax classification assigned to multiple individuals carrying on profit-seeking activities, according to Reg. §301.7701-3(b)(1)(i). The partnership provisions (see Reg. §301.7701-1(a)(2)) also add an element of dividing the profits derived from the trade, business, financial operation, or venture. The default to deemed partnership taxation is initiated under the Internal Revenue Code's expansive definition of partnerships that includes syndicates, groups, pools, joint ventures, or other unincorporated organizations through or by means of which any business, financial operation, or venture is carried on, as provided under §761(a) and §7701(a)(2) of the Internal Revenue Code. Under Reg. §301.7701-1(a)(1), an entity will be taxed under the partnership rules where it has made no affirmative tax elections with the IRS, whether or not the organization intends to be recognized as a partnership or any other type of entity under local law. In sub-regulatory rulings, the IRS went even further in asserting the federal preemption of default partnership tax status over local law, pronouncing in Rev. Rul. 144, 1953-2 C.B. 212:

"[T]he term 'partnership' for tax purposes is broader than the term under common law, the Uniform Partnership Act, or individual State laws. Accordingly, the Federal tax consequences of transactions involving partnerships and interests in partnerships will be determined upon the basis of their substance and in accordance with the Federal tax laws without regard to the technical refinements of State laws."

Notwithstanding the general default to deemed partnership taxation, not all joint undertakings are tantamount to a partnership, and Reg. §301.7701-1(a)(2) clarifies that the default to partnership taxation requires an element of dividing the profits derived from the trade, business, financial operation, or venture, and provides several instances of "mere co-ownership" arrangements that do not amount to separate, taxable entities:

"For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. 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."

The regulatory examples of "non-entities" not classified as partnerships or any other entity leave many questions to the imaginations of taxpayers and revenue agents, which tax courts must answer. Tax courts have affirmed partnership taxation even where carrying on a business


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through a joint undertaking is entered into with little or no formality. As Shakow notes, in *Podell v. Commissioner*, an oral agreement under which a taxpayer supplied funds to allow another person to rehabilitate homes, after which the two divided the profits, was treated as a partnership, and in *Bergford v. Commissioner*, taxpayers who were formally merely co-owners of computer equipment were deemed to be in a partnership with the manager of the sale-leaseback program through which they bought the equipment. The Court of Appeals accepted the Tax Court's conclusion that "the economic benefits to the individual participants were not derivative of their coownership of the computer equipment, but rather came from their joint relationship toward a common goal."

Even where a DAO is not carrying on a business, it still could default to partnership taxation by sharing the profits and losses of a "financial operation" under §7701(a)(2) and Reg. §301.7701-1. Although the term "financial operation" appears in the tax code and regulations, outlining the criterion for classification as a partnership, the term is not further discussed. Under this ambiguity, Treasury might consider a DAO to be engaged in financial operations by providing decentralized finance "DeFi" market infrastructure services, such as transaction validation, security, collateralization, or other liquidity functions. Other DAOs may be akin to specialist market-makers, in that their collective activities create and facilitate supply and demand for their own DAO tokens, leading to an increase in value of the DAO tokens.

Historically, the intent of the parties to join together in the conduct and ownership of the enterprise was a critical factor in determining whether a partnership existed. The Supreme Court said in *Commissioner v. Tower* (1946), "[t]he question arises whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both," and in *Commissioner v. Culbertson* (1949), "[t]he question is … whether, considering all the facts … the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." Rev. Rul. 75-43 illustrates the importance that can be placed on the expression of intent. In the regulatory example, two persons, an individual cattle owner and a corporate feed lot operator, agreed to a sharing of profits and losses in a cattle-feeding venture. However, they expressed no intent to form a partnership, their agreements being denominated a "service" agreement and a "guarantee" agreement. The IRS ruled that no partnership existed: "[P]rofit and loss sharing arises under the guarantee agreement and not because X has a proprietor's interest in the net profits or a proprietor's obligations to share losses." Probably, if the governing agreement had been denominated "partnership agreement" and the parties had filed partnership returns, the sharing of profits and losses coupled with the expression of the intent to form a partnership would have been sufficient to result in the existence of a tax partnership. In *McManus v. Commissioner*, members of the venture were precluded from denying their status as partners.

However, in more recent court cases such as *TIFD III-E v. United States*, as cited by Shakow, the finding of a taxable entity (most often a partnership) hinges around whether the participants cooperating in a co-ownership arrangement are sharing in both profits and losses from joint undertakings.

A considerable number of DAOs will meet the requirements of dividing profits and sharing losses to potentially fall into partnership taxation status by default, whether intended or not. In the original THE DAO, the investors planned to share profits from chosen investments, and ultimately, investors in THE DAO found that they shared in losses. To date, the IRS has not issued guidance or rulings concerning the tax classification of THE DAO or any other DAO's, leaving open questions of equal treatment of taxpayers in similarly situated DAOs.

### *Publicly Traded Partnership, International Taxation Defaults Are Possible*

By virtue of the generally widespread ownership of DAO tokens, many DAOs that would default into partnership taxation might also be subject to the publicly traded partnership (PTP) rules if they are traded on a cryptocurrency exchange that is deemed under §7704 and Reg. §1.7704-1 to be either an "established securities market" or a "secondary market (or the substantial equivalent thereof)" and might still meet the qualifying income rules to avoid corporate-level taxes and pass-through items of income and deduction to the DAO members under a tax regime similar to normal partnership taxation by earning at least 90% of income from qualifying sources, including dividends, royalties, and interest or other income listed in the internal revenue code. All other PTP DAOs would effectively be taxed as corporations for U.S. federal income tax purposes.

Perhaps more challenging to DAOs is that with no clear nexus to any jurisdiction, which is the case for many of them, they could default into international partnership taxation, as Shakow warned in an earlier Tax Notes article, *The Taxation of Cloud Computing and Digital Content*. This is because US tax law defines any corporation or partnership which is not formed under the laws of the United States or any state as a foreign corporation or foreign partnership. A DAO classified as an international partnership would be subject to a few international tax compliance requirements and provisions specially applicable to PTPs treated as partnerships. Where §7701(a)(4) provides that "domestic" means created or organized in the United States or under the laws of a US state "unless,


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in the case of a partnership, the Secretary provides otherwise by regulations," the IRS has yet to promulgate regulations with respect to the treatment of DAOs subject to partnership taxation.

A foreign PTP DAO would have significant tax compliance. There are different schedule requirements for different categories of international partnership activities and filers. For tax compliance, the US owners of a foreign partnership, are required to file a Form 8865 information return with the IRS to avoid a minimum $10,000-per-return penalty plus $10,000-per-month late penalty. In addition, an international partnership may have a Form 1065 filing requirement under Reg. §1.6031(a)-1(b)(3)(iii) to the extent it has US-sourced income or US partners.

Taxes applicable to a foreign PTP are also challenging. For example, ordinarily, an interest of 5% or less in a partnership (or corporation) that is regularly traded is not a US real property interest, even if the partnership is classified as a US real property holding corporation. Section 897(c)(3) and regulations provide this de minimis ownership rule. However, where a real property holding PTP is a foreign partnership or corporation, then the Foreign Investment in Real Property Tax Act (FIRPTA) withholding rules would apply to the transferor of the sale proceeds from disposition of a US real property interest.

A foreign PTP that otherwise meets all of the passive investment requirements to be subject to partnership taxation, might otherwise fall into corporate taxation due to US ownership. For purposes of the anti-inversion regime of §7874, Reg. §1.7874-2(g) provides that a foreign PTP classified as a partnership must be tested as a surrogate corporation in the same way that a foreign corporation is tested. *See* Kimberly S. Blanchard, 6680 T.M., *Partners and Partnerships—International Tax Aspects*, at II.C. An inversion of a PTP can therefore take place if a foreign PTP acquires substantially all of the assets of a domestic corporation and shareholders of the domestic corporation own 60% or more of the interest in the foreign PTP by reason of holding stock of the domestic corporation, and if such shareholders own 80% or more of the interests in the foreign PTP, the foreign PTP will be treated as a domestic corporation. *Id.*

If a DAO is a publicly traded foreign partnership that is treated as a corporation, and is also considered mostly owned by US persons, then it will be classified as a per se controlled foreign corporation under §957(a). As a CFC, a DAO would be subject to US tax on any effectively connected income (ECI) that is connected with a US trade or business, at the same rate as a domestic corporation, under §864(c)(8). Further, a DAO classified as a CFC that is deemed to have foreign subsidiary income could implicate either Subpart F income (§952) or the 10.5% plus surtax on Global Intangible Low-Taxed Income (GILTI) if the DAO had foreign subsidiary income (§951A). Finally, a CFC DAO with 75% or more passive gross income or 50% plus passive assets would possibly be deemed a passive foreign investment company (PFIC), subject to tax at the highest marginal tax rate of 37% and potentially imposing an additional requirement to file Form 8621 on the DAO owners (§1297).

### *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. We have taken a focused look at how profit-seeking DAOs could be taxed, given ambiguity in the tax regime and guidance that may have them default to entity classification as partnerships or publicly traded partnerships, and may subject them to international taxation. However, we are not without palliatives. DAOs can limit memberships and choose to organize in a US jurisdiction, or if a DAO cannot limit members, then a Real Estate Investment Trust (REIT) DAO may be a palliative in the case of real estate holdings consisting of tokenized real estate, or a Qualified REIT Subsidiary, pursuant to §851(b)(2)(A). Other investment DAOs that act as the functional equivalent of mutual funds or closed-end investment companies which hold passive securities, could elect taxed as Regulated Investment Companies under §856(c)(2).

However, DAO partnerships for trades and businesses, in which the members actively participate, could be anathema to the "decentralized" purpose of many DAOs. Profit-seeking uses for DAOs and their potential tax classifications represent only a fraction of the multitude of use cases for DAOs, making the path to determining the appropriate legal structures, regulatory compliance requirements, and tax compliance regimes for a DAO anything but standard.

Tax practitioners will be integral from the very inception and formation of DAOs to ensure that a DAO is not launched into a problematic tax regime. Brummer and Seira suggest a DAO entity selection decision flow that primarily considers (1) liability potential for off-chain activities or disputes, (2) tax advantages of incorporation depending on non-profit or for-profit activities, and (3) centralization. Additional features that influence the selection of DAO entities and the applicable tax regime is whether the DAO is Private vs. Public, or Temporary vs. Enduring. Some DAOs will be private, individualistic, and singular in their ego, such as captive computer applications. Other DAOs will be for collective purposes, whether cultural or social, as seen in the initial Precambrian explosion of DAOs thus far. As for temporality, not all DAOs aim for precarious perdurance across time to achieve amortality (although many DAOs do seek perpet-



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ual existence). Some will be temporary and expire of their own charter or by a defunct purpose. Add to these tax-impacting considerations the constant changes to DAOs as responsive, cybernetic systems, and the application of an entity form and associated tax classification as a legal anchor is much more challenging, as Wulf A. Kaal highlighted in *Decentralized Autonomous Organizations—Internal Governance and External Design*, Social Science Research Network at 27 (July 17, 2020).

Congress will need to carefully evaluate how DAOs function and whether existing tax and legal regimes, all of which require a human hand to shake (or throat to choke) will impede the technical possibilities of true decentralization and true autonomy in organizations. It may be that the IRS will need to provide the dual functions of amnesty and surveillance afforded by a sandbox study to make adjustments to the existing legal regime, or perhaps implement new taxation regimes specific to DAOs.

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