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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.

In this article, Diehl overviews decentralized autonomous organizations (DAOs), including the varying purposes of charitable and social purpose nonprofit, low-profit, and for-profit DAOs, and the related tax implications for how those organizations organize and operate.

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Introduction

The general concept of a decentralized autonomous organization (DAO) is that of a virtual entity with members who, with some level of majority, will collectively decide how the organization's smart contract programming should be changed so that the DAO can automatically allocate resources based on the programming. All DAOs use decentralized computer programs to run the algorithms automating some facets of their governance and management. Though many DAOs are crypto organizations residing on the distributed ledger known as the blockchain, not all DAOs live on the blockchain and some DAOs have nothing to do with crypto currency. The purposes for DAO communities span a broad spectrum of nonprofit and for-profit enterprises. The activities of these DAOs can be broken down into some general categories of (1) charitable and social purpose (nonprofit), (2) shared property and collections, (3) investment, and (4) governance or protocols.[1] This note will overview the tax facets of DAOs operating and organizing as charitable and social purpose DAOs.

Purposes and Mechanics of Charitable and Social DAOs

The charitable and social purposes for DAOs can address wide ranges of needs, including open-source computer programs, industry-supporting communities, public information and community service

[1]This list is organized based partly on the decision flow provided by Chris Brummer and Rodrigo Seira. *See* Brummer and Seira, "Legal Wrappers and DAOs," SSRN, at 30 (May 30, 2022); *see also* Bud Hennekes, "The 8 Most Important Types of DAOs You Need to Know," Alchemy Blog (Apr. 6, 2022).

system, charity grant-making,[2] and citizen science programs.[3] Social communities organized as DAOs promote social cohesion through distributed engagement around a shared interest that may not be for-profit or not-for-profit, such as investment clubs, social clubs,[4] art and gaming communities, and other hobby or interest groups. In the nonprofit and social space, DAOs enable identification of collective needs and offer incentives to directly meet those needs with less need for the intermediation of management through the algorithm, award of programmable tokens used as bounties to award an actor fulfilling the charitable or social DAO's needs.[5]

The basic mechanics used by most operating or grant-making charitable and social DAOs to fulfill their purposes are to: First, gather funds (or property); Second, issue governance or voting tokens (hereafter "voting tokens") to the contributing members and other constituency who will decide how the DAO should allocate its' resources; and Finally, issue incentive tokens to disburse (along with other funds or property) as grants and to the charities or service providers fulfilling the DAO's social and charitable purposes.[6]

Put differently, the purpose of a charitable grant-making DAO is to make algorithmically guided grants of award tokens or bounty tokens to qualified charities.[7] Alternatively, operating charitable or social DAOs which "directly" provide services can disburse funds or awards tokens to incentivize and compensate the service providers who carry

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[2]For an example of a grant-making DAO, see Aave Grants DAO.

[3]Many citizen science systems are being implemented for various science and environmental support purposes. For example: EcoBit in U.N. and Malaysia; 5 Gyres Institute's deployment of satellite and data-based monitoring; Global Fishing Watch; The Adopt a Hydrant Program by Code for America; and the Sustainia application of artificial intelligence to track illegal timber harvesting.

[4]Friends With Benefits DAO is an example of a social DAO that holds one-off events and larger events around the country. Often described as a "financial flash mob," or "group chats with bank accounts." *See* Erin Woo and Kevin Roose, "This Social Club Runs on Crypto Tokens and Vibes," *The New York Times*, Mar. 2, 2022.

[5]As an example, The Bounties Network platform awards tokens to reward freelancing in grassroots social action. Other DAO's incentivize work on open-source computer programs, work on environmental and social issues, or citizen science and research.

[6]Note that the mechanics of DAOs used as support organizations or feeder organizations to nonprofit organizations will be significantly different.

[7]Not all incentive and award tokens have intrinsic value, and some function more like badges with no value to commemorate achievements or advances in learning and education.

out the social or charitable activities of the charitable or social purpose DAO.[8]

Charitable or social purpose DAOs can issue different types of tokens with intrinsic or extrinsic monetary value. Some of these valuable tokens are incentive tokens, used to compensate independent service providers to carry-out needed services for the DAOs or other tokens are used to make grants to other charities. Charitable and social DAOs will usually also issue tokens for use by the constituency as voting tokens, which may or may not have intrinsic or extrinsic value, depending on the token terms. A token-issuing DAO faces significant regulatory risks and liabilities with respect to tokens that have intrinsic or extrinsic monetary value. Even if a charitable or social purpose DAO is tax-exempt as a 501(c) charity, a tax-exempt DAO issuing incentive tokens should consider restrictive or protective mechanisms applicable to the DAO tokens, and possibly segregate the token issuance and disbursement into separate juridical entities.[9]

Voting tokens in a charitable or social DAO with no monetary value can be analogized to the voting rights of members of a traditional non-profit, and voting tokens are not akin to ownership in the non-profit, which is not permitted. Once a governance or voting token is used for a vote by a member of the DAO, the nonfungible voting tokens can be made to programmatically expire and/or to collect a record of the vote in the voting token's associated data block (if on the blockchain). A charitable DAO's voting tokens can be made innocuous by ascribing no intrinsic value to them and by preventing extrinsic value by making the voting tokens non-transferrable, thus proscribing collector, social, relational, or other market trading value. On the other hand, the membership tokens of some non-

[8]It should be noted that tokens earned by service providers to the DAO would subject the service providers to taxation rules for earned income.
[9]Many practitioners forming DAOs utilize international jurisdictions for organizational wrappers to act as the token issuer or as a parallel DAO to the US DAO in cases where a nonprofit DAO wishes to issue tokens to incentive service providers. Some jurisdictional options for DAOs include Swiss Decentralized Autonomous Association (DAA), Malta Innovative Technology Arrangements, Singapore DAOs, Marshall Islands LLCs, ownerless foundation companies based on the laws of Switzerland or Cayman Islands, or foreign special purpose trusts, cooperatives, foundations, associations or private trust companies based on the laws of The Cayman Islands, Guernsey, Panama, British Virgin Island, Ireland, Liechtenstein, or the Cook Islands. See generally Chris Brummer and Rodrigo Seira, Legal Wrappers and DAOs, Social Science Research Network, at 30 (May 30, 2022); see also https://corpgov.law.harvard.edu/2022/09/17/a-primer-on-daos/

charitable, non-social welfare, social DAOs may have some intrinsic membership value, alongside the voting and governance function.[10]

A charitable or social DAO's incentive tokens for incentivizing work by service providers to carry out the charitable or social DAO's purposes, or incentive tokens issued and disbursed as grants to qualified charities, must have intrinsic value and extrinsic exchange value to be useful. Otherwise, the charitable or social DAO will be ineffective at both carrying out its' activities and making grants. An additional practice for issuing tokens with intrinsic value for tax-exempt charitable DAOs, to avoid potential disqualification by private inurement or private benefit risks, is that the charitable DAO should hold and control all incentive tokens, or better-yet, issue the tokens from and hold the tokens in an entity controlled by the charitable DAO until disbursement. Any charitable DAO tokens with intrinsic or extrinsic value should not held by the DAO members under any circumstances.[11]

If the tokens are held directly by a domestic US DAO rather than the holder, the service might argue that a charitable or social DAO's aggregate activities of creating both supply and demand for the DAO's appreciating incentive tokens constitute an enterprise generating unrelated taxable business income, for which no charitable tax-exemption is permitted.[12] Dealing with the UBTI arising from incentive token issuance again points to a possible solution through the issuance of DAO incentive or value tokens by a Controlled Foreign Corporation DAO without Effectively Connected Income to the United States.[13]

Charitable DAOs as Informal Alliances Will Likely Be Assigned a Tax Status

A Charitable DAO can easily be deployed using turnkey technologies as an informal alliance (often as an online forum),

[10]In particular industry associations under 501(c)(6) or country clubs under 501(c)(7).
[11]Note that this is particularly applicable to charitable and social welfare DAOs. A 501(c)(6) industry association or 501(c)(7) social club, as discussed later, may be able to issue some award or incentive tokens with intrinsic value to be held by members, subject to restrictions on transfer, analogous to issuing prepaid club credits.
[12]The service might argue that the DAO issuance of tokens is tantamount to regularly carrying on a trade or business of investing unrelated to the charitable or social purposes of the DAO. See Generally IRC section 512 generally.
[13]*See* PLR 199952086, PLR 200251016, PLR 200252096, and PLR 201043041.

without a formal entity structure or entity tax classification.[14] It is important to consider that nearly all enterprises that carry-out any meaningful amount of social or charitable activities (with an economic footprint that includes value changing hands) are shoehorned into some sort of entity status under state laws and assigned a tax status by the federal government, bringing into question the feasibility of an informal DAO with no express organization.[15] To counter against the default entity status, members of an informal DAO for social or charitable purposes might assert that a DAO with no formalized entity structure is either exempt from taxation and tax filing as 508(c)(1) charity, or if not a charity, the DAO is exempt from tax filings as merely a co-ownership arrangement[16] rather than a traditional enterprise.[17]

An informal charitable DAO's argument that it is not required to file for tax-exemption could be one or more of: A) the DAO has less than $5,000 of annual gross receipts and is carrying out an exempt charitable purpose under IRC section 501(c)(3);[18] B) the DAO is operating as a community chest, trust or fund association if the DAO is used for making grants to IRC section 170 qualified charities;[19] C) the DAO is an instrumentality of a tax-exempt organization as a support organization[20] or a feeder Organization;[21] or D) the DAO is a church, or the integrated auxiliary of a church.[22] If the DAO is not a church or community chest, is not an instrumentality of a nonprofit, or is otherwise financially successful in obtaining more than $5,000 in annual gross receipts for the DAO's purposes, the DAO will not

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[14]Note that under IRC section 508, the exemptions from applying for recognition of 501(c)(3) status do not apply to social welfare organizations under IRC 501(c)(4), do not apply to industry associations under IRC 501(c)(6), and do not apply to social clubs under IRC501(C)(7).

[15]Partnership is often a deemed status for multiple individuals for both state and federal liability purposes, regardless of whether the organization intends to be recognized as an entity under local law. *See* reg. section 301.7701-1(a)(1).

[16] See Generally Treas. Reg. § 301.7701-1

[17]Professor David J. Shakow posits that "pure cryptocurrencies, like bitcoin, are based on a blockchain structure, but they do not reflect an ownership interest in any entity." *See* Shakow, "The Tao of the DAO: Taxing an Entity That Lives on a Blockchain," *Tax Notes*, Aug. 13, 2018, p. 929.

[18] See IRC § 508(c)(1).

[19] If a community chest DAO were using award tokens for charitable grants, the DAO itself would need to donate those tokens to a tax-exempt organization that is willing to accept the token and that would carry out the charitable activities. The community chest or alliance itself could not normally carry out any tax-deductible activities.

[20]*See* IRC 509(a)(3)

[21]*See* IRC section 502.

[22]*See* IRC § 508(c)(1).

likely be unsuccessful in its' argument that it need not apply for tax exemption.

Some DAOs that have less than $5,000 in annual gross receipts perform services which the DAO's community considers charitable, but that the Internal Revenue Service may not consider charitable. In one recent example, programmers working on an open-source computer program or protocol organized as a DAO applied for exemption under 501(c)(3) as an educational organization, and the DAO group later requested a private letter ruling after the IRS rejected the group's application for tax exemption. The DAO had been issuing some incentive tokens for work by the members on an open-source computer program, and the service held that the DAO producing the open-source software was not a charitable or educational activity under 501(c)(3), but rather a guise to pay the programmers for work using bounty or incentive tokens.[23]

If an informal charitable or social DAO is not exempt from applying for tax-exemption, to avoid deemed tax status as a partnership,[24] the DAO could make the argument that it is merely a co-ownership or joint-use of property arrangement, and therefore still a non-entity for entity-level tax reporting purposes. [25] The argument by the informal DAO would be that rather than carrying out a profit and loss sharing enterprise, as would be anticipated with a traditional enterprise, the informal DAO is merely holding property for the benefit of the DAO members. Under this argument, the DAO would need to convincingly show that the DAO token holders will not share any profits or losses from the labors of others, as seen in most business enterprises, making the imposition of a deemed business status inappropriate.[26] The argument would go that, given the lack of a

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[23]*See* PLR 202019028.

[24] See Treas. Reg. §301.7701-3(b)(1)(i).

[25]In allowing an organization to elect out of the default partnership status, the Treasury secretary may exclude the organization from the partnership rules at the "election of all the members of an unincorporated organization, if it is availed of . . . for the joint use of property." Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased doesn't constitute a separate entity for federal tax purposes. For example, an individual owner (or tenants in common) of farm property leasing that property to a farmer for cash or a share of the crops doesn't necessarily create a separate entity for federal tax purposes.

[26]That is consistent with uniform law, which provides that "the 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

profit seeking and business purpose, the nature of the property-sharing DAO makes it inappropriate for the IRS to deem it a partnership for state law or federal tax purposes.

However, making the argument that an informally organized charitable DAO is a mere property-holding arrangement for purposes of avoiding an imposed entity tax status and tax-filing requirements raises diverse challenges and ultimately runs the DAO into dead-ends. For starters, the contributors of funds and property to the charitable or social purpose DAO would be prohibited from deducting their contributions to a DAO that is not exempt under IRC section 501(c).[27] Further, the DAO itself cannot operate to provide services that effectuate the DAO's social or charitable purpose because the expenses (losses) from co-ownership (normally reported on Schedule C or E) would not be tax deductible to the persons who contributed/donated to the DAO.

The lack of deduction for contributions to an informal DAO co-ownership arrangement leaves the DAO with the option to hold the non-deductible contributed funds until the DAO contributors ask for disbursement so that the contributors can themselves directly donate to a tax-deductible charity.[28] By holding charitable funds or tokens until disbursed back to the donors for their direct contribution to qualified charities, the DAO will either be acting as a custodian of the funds (bank) or an investment fund if the DAO invests the proceeds or issued tokens with intrinsic value in hopes that the tokens appreciate.[29] Whether the DAO is holding tokens for use in carrying out activities or investing the funds contributed to the DAO for later

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returns are derived." *See* the Revised Uniform Partnership Act, section 202(c)(1997).

[27]*See* IRC section 170.

[28]In addition to potential issues of private benefit and inurement, as well as Unrelated Business Taxable Income, the incentive tokens could increase in value in the hands of a person before the tokens are awarded to incentive work on the DAO's exempt purpose, and when the appreciated incentive tokens are donated, the token holders must report the depreciation as either ordinary or capital income, depending on the characterization of the tokens and the taxpayer's status as dealer, trader, investor, hobbyist, or nonprofit.

[29]Note that the arrangement of a charitable organization (or the separate instrumentality of a charitable organization) holding investment funds is permitted in numerous arrangements (such as Donor Advised Funds or pooled income funds). Typically, investment funds maintained by charitable organizations are excluded from regulation under the Investment Company Act of 1940 (1940 Act) pursuant to Section 3(c)(10) of the 1940 Act, but in this instance, an informal DAO with no tax exemption would not qualify for the exemption to hold or invest funds without being subject to the Investment Company Act.

donation by the contributor, by issuing tokens and holding them, the holding-DAO is subject to diverse pitfalls in the form of regulations and taxation at the entity-level.[30] Neither of these approaches appears to effectuate the intended charitable or social purposes of the DAO.

While it is technically feasible to create a charitable or social DAO that is not organized for state or federal purposes, the benefits of doing so in isolation from a traditional nonprofit are not obvious, and the DAO's lack of organization is fraught with risks. In the case of an informal charitable DAO operating as a community chest, the DAO cannot conduct substantial charitable activities, and in the case of a DAO carrying out charitable activities itself, the DAO may not be able to issue tokens without substantial risks to itself as discussed elsewhere in this paper.[31] Practically speaking, all charitable or social purpose DAOs — whether operating as community chests to make grants, or carrying out active charitable or social purpose activities — would likely want to adopt the structural model of a juridical entity or an unincorporated nonprofit association, and file for tax exemption or file a tax election or application for tax exemption to achieve certainty of their entity tax status.

For-Profit and Low-Profit Socially Beneficial DAOs

Social Enterprise DAOs with a combined goal of profit and purpose have several for-profit organizational options available, including developing a corporate social responsibility program or organizing as a benefit corporation or benefit limited liability company.[32] The many potential organizational classifications and taxation regimes relevant

[30]Unrelated Business Income taxation at the entity level under IRC section 511 is a very likely issue that would, by itself necessitate filing a schedule 990-T.
[31]Not all DAOs necessarily need to issue tokens, though the issuance of tokens is often seen a quintessential characteristic of DAOs.
[32]Both benefit corporations and benefit LLCs remove or limit the duty of directors, officers, and managers to maximize profits to shareholders, instead emphasizing a duty to carry out environmental or socially responsible activities that are beneficial to the broader stakeholders of the company.

to for-profit DAOs[33] are addressed elsewhere.[34] But it is beneficial to outline some considerations for a DAO that is intentionally organized as a for-profit LLC or corporation that also conducts charitable activities.

While a for-profit DAO organization may be tempted to play a belligerent do-gooder role and use their income to provide charity under the radar by deducting the expenses for the charity, the donating organization is susceptible to egregious IRS sanctions for their vigilante philanthropic activities.[35] For-profit companies, including benefit corporations and benefit LLCs, cannot directly perform tax-deductible charitable activities because if a for-profit company wishes to receive a deduction by contributing services to charity, compensating personnel for donating time to charity, or donating inventory or profits to charity, they must direct the contribution through a tax-exempt charity.[36]

As noted, partnership is the default status of most organizations, and a benefit LLC — absent an election to be taxed as a C corporation — would likely be taxed as a partnership. Overall, partnership tax laws would interact awkwardly with the operation of a DAO, regardless of whether it is for-profit or nonprofit.[37] The considerable complexities of administering a partnership; issuing Form K-1's when filing taxes; allocating items of income, deduction, and loss; and tracking outside basis make a partnership structure onerous for a DAO's token holders.[38]

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[33]The spectrum of possible legal statuses begins with individual sole-proprietors and joint ventures of people on the one end, partnerships in the middle, continuing to LLCs and corporate associations with a separate legal existence and taxpayer status from the members on the other end of the spectrum. That continuum is punctuated by classifiers such as trusts, cooperatives, partnerships, LLCs, and corporations. Like the animal kingdom, the classifiers don't always draw sharp distinctions, and there are some hybrid classifications.

[34]*See* Shakow, *supra* note 7.

[35]*See* sections 6662 and 6663.

[36]Section 170.

[37]The difficulty in administering a partnership arises primarily because of their passthrough character, which allows items of income and loss to pass through directly to the members of the partnership. Once the partner has been allocated an item of loss or income, they include the income or might deduct losses on their personal income taxes. Unlike corporations, the allocations of partnership income and losses are generally flexible, permitting the partnership to allocate more profits to one partner or more losses than other partners. *See* section 704.

[38]It could also be difficult to find an individual willing to take on the liability of a general partner and play this scapegoat role on behalf of a

Given the DAO's crypto-anarchic roots and culture of throwing off the saddle of government, it is questionable whether a DAO community that has hitherto not organized would be willing to intentionally elect to be taxed as a partnership and tolerate the paper pushing, comply with the reporting, or entertain the taxation complexities required by the use of partnership organizational structures.[39] The awkward incongruity of the laws generally make a benefits LLC with partnership treatment of a charitable DAO incommensurable with the ideology of the DAO's participants.

Alternatively, a DAO might organize as a corporation, subject to entity-level taxation at today's corporate income tax rates of 21 percent.[40] As with all entities, corporate organizations come with requirements and formalities of governance, so a DAO organized as a corporation must carefully design its governance structure.[41]

Overstock.com was one of the first companies to issue conventional stock using a blockchain structure. To comply with regulatory requirements, Overstock overlaid the blockchain structure with an entity, the Overstock corporation itself. The corporation was responsible for filing tax returns for the blockchain stock and issuing tax forms to the investors when they were paid dividends. Overstock appears to be more hype and proof of concept than actual DAO; amalgamation of both the blockchain and a traditional entity-overlay structure is seen as sacrilege by some crypto purists.[42] However, an adaptation of the corporate structure may be the only safe

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disembodied community. However, regardless of the willingness of a DAO to organize as a partnership, under state laws, the DAO might still be deemed a partnership and thereby impose vicarious partner liability on the DAO. That could easily occur in litigation, during which a plaintiff suing a DAO could request that a court impose partnership liability on the DAO members.

[39]An election to be taxed as a partnership can be made under reg. section 301.7701-3.

[40]It is important to note that if more than 50 percent of the DAO's issued tokens were concentrated in the hands of a few parties or related parties, the personal holding company taxation rules could cause an additional layer of 20 percent tax to apply to a DAO. *See* section 542.

[41]For example, a DAO corporation would need to appoint officers and a board. The corporate bylaws of a DAO could provide for a self-perpetuating board in which members are elected by other members of the board. Alternatively, the DAO could be programmed to allow the shareholders/token holders to elect the corporation's board and the board. In either case, the board would appoint human officers for the DAO. However, this centralization may be in conflict with the fundamental decentralized consensus mechanisms and characteristics of any DAO.

[42]Perhaps an alternative to corporations might be developed by states or adapted to fit DAOs. Some concepts from mutual benefit corporations or water companies might appropriate to model a new entity type.

harbor for a DAO unless lawmakers allow an entirely new type of entity.[43] Handling U.S. tax rules would certainly be a requirement of any charitable DAO, making a corporation with a social responsibility program or a benefit corporation a reasonable entity choice for operating a charitable DAO.[44]

One major constraint for charitable and social DAOs organized as corporations is that corporations are generally limited to a 10 percent deduction for their contributions to tax-exempt charities.[45] However, for-profit organizations that use purposes and profits to brand themselves may make tax deductible donations to a section 501(c)(3) organization for advertising purposes and maintenance of goodwill in addition to taking deductions for necessary and ordinary business expenses that exceed the normal 10 percent deduction limitation for charitable contributions.[46] The stifling 10 percent contribution limitation could be overcome by a joint venture with a nonprofit — with the corporation being owned, at least in part, or controlled by a tax-exempt charity that is entitled to a portion of the after-tax profits as a shareholder of the Corporate DAO.[47] In any case, the profits passing to the tax-exempt charity from a charitable DAO corporation would be after-tax profits.[48]

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[43]As Shakow notes, rather than using the pure blockchain structure, after Overstock.com organized blockchain-based securities, the blockchain-corporation amalgamate has become a preferred entity structure for many DAOs that must deal with IRC issues. *See* Shakow, *supra* note 7.

[44]Most benefit corporations and benefit LLC statutes require annual reporting of philanthropic activities to a state authority. At the core of the trouble with finding an appropriate entity structure for a nonprofit DAO is that all traditional entity structures require a responsible human being and a physical address. Perhaps state or federal lawmakers will need to reconsider these requirements and allow for an alternative accountability mechanism.

[45]*See* section 170(b)(2)(A). Corporations — subject to a 10 percent limit — can sometimes take deductions under section 162, without the deduction limitation in INFO 2016-0063, which provides that for-profit organizations may make tax-deductible contributions to a section 501(c)(3) organization for advertising purposes and maintenance of goodwill. Additional, often enhanced deduction limitations may apply to donations of food or cash contributions.

[46]*See* section 162.

[47]Only a DAO entity taxed as a C corporation, with an entity-level tax can prevent inclusion of UBTI in the owner-nonprofit. A passthrough entity such as a partnership or sole proprietorship might cause the nonprofit owner to fail the public support test. A nonprofit cannot own an S corporation without causing termination of the S-Corporation election and reversion to C-Corporation, and a rollback of retroactive entity taxation.

[48]Caution must be exercised in structuring joint ventures with DAOs. *See* GCM 39005; *Plumstead Theatre Society Inc. v. Commissioner*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982). The court in *Plumstead* applied a close scrutiny test so that the first, tax-exempt organization furthers its exempt

While for-profit organizations provide DAOs some relief from centrality of control and other requirements of a purely charitable, tax-exempt entity, the use of charitable deductions will still subject for-profit organizations to many corporate organization requirements. Further, caution should be exercised to avoid recharacterization of a public charity as a private foundation, or even termination of tax-exempt status.[49] At best, for-profit DAOs organized to coordinate charity through corporations with social responsibility programs or directing charity through benefit corporations may reduce some of the tax-exemption organization and operational requirements the DAO would otherwise face, but it can't eliminate them. As noted, charitable DAOs organized as for-profit corporations cannot be purely charitable, are limited in the amount of tax-exempt charity they can provide and must conduct all charity through a tax-exempt organization.

Private Foundation Charitable DAO Types

Any DAO forming a section 501(c)(3) organization, whether public or private, should ensure that the DAO activities are charitable, scientific, or educational and that no substantial part of their activities is seen as an attempt to influence legislation.[50] Following initial application for tax exemption by the DAO, and an IRS determination that it qualifies as a tax-exempt organization, the DAO must also file annual Form 990 tax returns.[51] That requires an authorized person, appointed by and responsible to the DAO; the DAO will need to vote for the appointing of a professional such as an attorney or a CPA to fill that key role.

Because Charitable DAOs are frequently founded and funded by a concentrated number of initial contributors, a charitable DAO with few founders or concentrated support might be deemed a private foundation

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purpose and retains sufficient control over the joint venture, typically achieved by either ownership or voting provisions. *See* Rev. Rul. 2004-51, 2004-1 C.B. 974; *see also John Gabriel Ryan Association v. Commissioner*, No. 16811-02 (T.C. 2002); *see also Redlands Surgical Services v. Commissioner*, 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001).

[49]Additional issues can affect qualification for tax exemption in joint ventures between charities and for-profit entities. First, upon entering into a DAO joint venture, the charitable organization may have difficulty meeting public support requirement. Second, should the public support test not be met, the organization would become a private foundation, becoming subject to the excess business holdings limitations under which the private foundation may be required to immediately divest a portion of the joint venture DAO interest.

[50]*See* section 501(c)(3).

[51]*See* section 6033.

by default, or a charitable DAO may be intentionally organized as a private foundation because of a lack of broad support for the group organizing the charitable DAO.[52] Because private foundations receive most of their financial support from a few individuals or entities, they are subject to limitations and restrictions not applicable to public charitable DAOs supported by a broader base of donors.[53] Also, among private foundations, the IRS draws important, tax-effecting distinctions based on levels of public support and whether the foundation's activities are passive or active. Private foundations are classified as either grant-making private foundations (nonoperating), private operating foundations (actively carrying out charitable activities),[54] or exempt operating foundations that both actively carry out charitable activities and are broadly supported.[55]

A grant-making (private nonoperating) foundation passively contributes money to public charities and is subject to distribution requirements as well as investment income taxes.[56] As an example of the effect that the private nonoperating foundation classification has on the treatment of a charitable DAO, consider that a tax-exempt DAO set up by a few supporters for the purpose of granting tokens to public charities would be subject to the private foundation distribution requirements, income excise taxes, and undistributed income excise tax rules.[57]

The distribution requirements imposed on grant-making foundations could exhaust a grant-making DAO foundation's charitable corpus after a few years as the DAO (on threat of a punitive excise tax) annually made distributions based on a "minimum investment return," which is about 5 percent of the fair market value of the DAO's assets or be liable for a 30 percent excise tax on the undistributed income.[58] That amount is calculated to deplete the corpus of the DAO over time, and a

[52]Embedded in section 509(a) is a presumption that every section 501(c)(3) organization is a private foundation unless it qualifies as a public charity under section 509(a)(1)-(3).

[53]Upon application for tax exemption, the IRS will permit a new section 501(c)(3) organization to be classified as a public charity for its first five years if its application shows that it can reasonably be expected to be supported by the public or closely associated with a public charity. Following those initial five years, the IRS will monitor the organization's public support by requesting additional information using information from Schedule A of Form 990.

[54]*See* section 4942(j)(3).

[55]*See* section 4940(d).

[56]However, these grants are still subject to strict expenditure responsibility requirements. *See* section 4945(h).

[57]*See* sections 4942 and 4940.

[58]*See* section 4942(e)(1).

foundation will face increased penalties or termination if it fails to make the grants or expenditures. Complying with the annual distribution requirements could create complex distribution issues for a grant-making DAO that issues governance or voting tokens, especially with market volatility creating challenges for the valuation of the DAO's token assets. From a governance perspective, where the purpose of a DAO is to provide the voting members of the charitable DAO with a say in the DAOs grant disbursements, contrary to the decentralized tenants of DAOs, a private, grant-making DAO foundation should retain plenary, overriding distribution authority centralized in the hands of a few directors for the purpose of ensuring compliance with distribution requirements.

If a charitable DAO with few supporters were designed to hold tokens that could compensate agents for actively carrying out charitable activities in support of the DAO's charitable purposes, the DAO might be treated as a private operating foundation and thus be subject to lesser distribution requirements, while still facing income and other excise taxes. Further, if a DAO that actively carries out charitable activities has been publicly supported for at least 10 years, it could be treated as an exempt operating foundation and would be subject to lesser distribution requirements and no income excise taxes, although the other excise taxes would still apply.[59]

Taxes on Private Foundation Charitable DAOs

In addition to entity-level taxation and distribution challenges for a private foundation charitable DAO, donors face deduction limitations on contributions to private foundations that are more limited than the deduction that a donor can take for donating to a public charity.[60]

A charitable DAO that is deemed to be a grant-making (private nonoperating) foundation or a private operating foundation may have a limited shelf life for several reasons. First, the shelf life is limited because passive or narrowly supported private foundations, although tax exempt, cannot enjoy tax-free growth of their investment assets like broadly supported public charities do and are subject to a

[59]The "publicly" supported test for exempt operating foundations is not as broad as the support test for private operating foundations under section 4942(j)(3)(B)(iii).

[60]Operating foundations are afforded reprieve from the deduction limitations imposed on grant-making private foundations and are afforded the same deduction limitations that apply to public section 501(c)(3) charities. *See* section 170(b)(1)(A)(vii).

tax of 1.39 percent on the foundation's net investment income.[61] For example, if a grant-making charitable DAO were to sell some of the tokens, funds, or digital currency that it holds in reserve, the income received by the DAO might be characterized as gross investment income and thus be subject to the excise tax on net investment income under section 4940.

A grant-making DAO might also struggle to survive when taxed as a private foundation because of the earlier discussed requirement to make grants or expend about 5 percent of their net investment assets each year.[62] However, a DAO could set aside funds for program-related investments in businesses that support the purpose of the charitable DAO, or it could make qualified set-asides of the required distributions in order to fund a charitable purpose within 60 months of the set-aside.[63] In both cases, a private foundation must be wary of excise taxes on related-party self-dealing prohibitions as well as "jeopardy investments." The issues with related-party transactions could arise if a charitable DAO were to engage in token repurchasing from the token holders under section 4941(d)(1)(A).

The jeopardy investment issues could arise when a private foundation invests in the tokens of a DAO, or if another nonprofit DAO invests in other cryptocurrencies or other DAO tokens. The rules define jeopardy investments as those that jeopardize the carrying out of any of a private foundation's exempt purposes.[64] To deter private foundations from making such investments, the IRS imposes onerous excise taxes on the organization and the organization's management until the investments are sold.[65] Given the high degree of market volatility inherent in tokens — as well as the potential for a hard fork by DAO members — investment by a private foundation in cryptocurrencies might be considered a jeopardy investment.

To avoid the jeopardy investment excise taxes, it is prudent for a private foundation acquiring tokens to limit their holdings in a DAO to appropriately insubstantial portions of their overall investment

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[61] *See* section 4940(a), except that an exempt operating foundation that is publicly supported under the private operating foundation rules is not subject to the excise taxes on income under section 4940(d).

[62] *See* section 4942.

[63] *See* section 4942(g)(2).

[64] Section 4944(a)(1).

[65] Because the jeopardy investment rules do not apply to public tax-exempt organizations, a DAO operating as a public charity or a public section 501(c)(4) or 501(c)(6) organization would not need to consider its token holdings under jeopardy investment rules like a private foundation. *See* section 4944.

property. Further, a private foundation may want to exempt their token holdings from the jeopardy investment rules by qualifying the token acquisitions as program-related investments made primarily for the unique charitable purposes delivered by a nonprofit DAO, not for producing profits.[66]

A charitable DAO private foundation that holds stakes in enterprises would also be subject to onerous excise taxes on excess business holdings when it owns more than 35 percent of a business enterprise (such as a DAO), or more than a combined 20 percent of a business enterprise in conjunction with disqualified persons such as managers and major contributors.[67] As with jeopardy investments and taxable expenditures, a public section 501(c)(3), 501(c)(4), or 501(c)(6) organization that acquires tokens or receives tokens by gift will not be subject to the excess business holding rules, unlike a DAO taxed as a private foundation.[68] The excess business holdings rules should not apply to a foundation holding tokens in a DAO that is functionally related or operating as a nonprofit rather than as a business enterprise.[69] That could permit a private foundation to purchase and hold tokens from a nonprofit DAO without being subject to the excess business holdings excise taxes.

Private foundations will also need to be careful of punitive taxable-expenditure excise taxes when making grants to nonprofit DAOs.[70] To avoid those taxes, a private foundation should ensure its ability to exercise expenditure responsibility over the DAO.[71] Expenditure responsibility requires that the private foundation see that the grant is spent solely on the intended purposes made and obtain detailed reports from the DAO.[72]

Because DAOs are operated by computer code, obtaining detailed transaction reports on uses of funds is achievable. However, the autonomous nature of a DAO could make the exercise of dominion over the DAO tenuous, if not impossible. That surrender of control emphasizes the need to investigate the operation of a DAO — and even the syllogisms and computer code underlying the tokens — before making a grant to a DAO. As noted earlier, it is necessary to centralize certain governance and control over charitable private foundation DAOs

[66]*See* reg. section 53.4944-3.
[67]*See* sections 4943 and 4946.
[68]*See* section 4943.
[69]Section 4943(d)(3).
[70]Section 4945.
[71]Section 4945(h).
[72]Section 4945(h)(1) and (2).

into the hands of certain board members. Of course the DAO can effectuate decentralized voting mechanisms to elect the centralized board-members and provide restricted governance or voting token to the board.

Those constraints and excise taxes suggest that a charitable DAO seeking true decentralization would be best to seek qualification as a public charity to overcome the limitations that might shorten the life of the DAO because of the distribution requirement and to avoid the excise taxes and penalties that are imposed on private foundations. However, for concentrated philanthropic purposes, a DAO must live with these restrictions and restraints.

DAOs as Section 501(c)(3) Public Charities

To apply for recognition as a section 501(c)(3) public charity, in addition to meeting the rules earlier outlined to qualify as a charity, a DAO must also meet the test for broad public support under section 509(a). Given the distributed, public nature of a DAO, it would likely have a broad constituency for qualification under the public support test. However, even if the DAO was broadly supported, and the DAO's funds were to be used for charitable purposes, it may be challenging for a DAO to qualify for exemption as a public charity under the section 509(c)(2) public support test due to some traditional DAO token issuance practices.

Typically, a for-profit DAO will raise funds by issuing tokens in exchange for transfers of money, property or securities – sometimes in the form of cash, but other times in the form of digital assets or tokens. If a charitable DAO raising funding for it's charitable purposes were to follow the traditional practice and issue DAO tokens with intrinsic or extrinsic value in exchange for money or property,[73] instead of receiving donations in exchange for no value, the DAO may

[73]A nonprofit DAO's tokens might initially be issued in exchange for cash or an established digital currency like Ethereum (ETH), with the ETH to be held for some before distribution while the underlying economic ecosystem of the DAO gains viability. Note that individuals, partnerships, and corporations file Form 8283 to report information about noncash charitable contributions, such as ETH, when the amount of their deduction for all noncash gifts is more than $500. See IRS Frequently Asked Questions on Virtual Currency Transactions, https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions (last updated August 18, 2023)

fail the public support test due to unrelated business taxable income rules.[74]

The quid pro quo transaction of issuing tokens with value in exchange for contributions to the DAO would be considered a sale of assets rather than a pure contribution to the charity or traditional receipt of program revenue for sale of goods or services substantially related to the DAO's nonprofit purpose under the public support test. As an additional issue, if the tokens issued by the DAO have value, the deduction for contribution to the DAO would be limited to the amount of the contribution, less the present value of the token.[75]

However, if the tokens issued by the charitable DAO are restricted to voting on the allocated DAO resources for the provisioning of charitable services, a nonprofit DAO could assert that tokens purchased by donors are considered program revenue issued for purposes of allocating the DAO's charitable services. However, the sale — as a funding mechanism — of charitable DAO tokens that are not used to provide services or allocate services would not qualify as program revenue in qualifying the DAO for public support purposes. It is especially unlikely that a DAO would be able to qualify the tokens as program revenue when the tokens themselves are not restricted for DAO governance purposes but have an intrinsic utility value or an extrinsic value if the DAO tokens are exchanged as property or currency.

An existential risk for DAOs is that the issuance of a voting or governance token to a member or stakeholder by a nonprofit DAO could be perceived as creating authority to act or speak on behalf of the DAO by the member on political issues. Charitable DAOs issuing a token, like any corporation issuing a new class of stock, will need to be clear on the rights and authority of the token-holder regarding the charitable DAO. Otherwise, a section 501(c)(3) DAO with unclear member authorizations and rights may see its' members interact with government officials on behalf of the DAO.

A nonprofit DAO otherwise exempt from income taxation under section 501(c)(3) may conduct "no substantial part" of its activities to influence legislation and must not participate or intervene in any political campaign whatsoever.[76] Also, a section 501(c)(3) organization must not be an "action organization" that has a primary purpose of advocating for the enactment or defeat of legislation. For a section

[74]Section 509(a)(2)(A)(ii).
[75]*See* IRS Publication 526 (2022), Charitable Contributions.
[76]*See* section 501(c)(3).

501(c)(3) DAO to conduct lobbying activities that are considered "insubstantial," the activities must be less than 5 percent of the organization's total activities.[77] Alternatively, a section 501(c)(3) DAO engaging in legislation political activities could elect under section 501(h) to permit some lobbying based on the DAO's budget, subject to penalties for excess expenditures.

If a section 501(c)(3) DAO or DAO members were to engage in political activities that exceeds those limits, the DAO risks termination of its tax exemption.[78] A prudent approach to mitigating that threat would be for the DAO to publish a statement of authority outlining the limitation and stating that the token remuneration given to agents in exchange for providing charitable services is conditioned on the communication being apolitical and non-lobbying. Additionally, restrictions on political activities should be layered on top of any governance or voting tokens, in addition to the other terms applicable to the tokens.

Support and Feeder Organizations

A DAO organized and operated exclusively for charitable purposes or in connection with a public charity, but not meeting the public support criteria for an independent charity might qualify as a support or feeder organization.

A DAO that cannot meet the public support test by itself might be able to qualify as a support organization under section 509(a)(3). An organization wishing to change its public charity classification in IRS records, including a supporting organization requesting a determination as to whether it is a Type I, II or III supporting organization, must file Form 8940, Request for Miscellaneous Determination. Support organizations perform the functions and carry out the purposes of an independent, tax-exempt section 501(c)(3), 501(c)(4), 501(c)(5), or 501(c)(6) entity. However, qualification requires that the DAO is engaged in charitable activities, performs integral activities for a section 501(c)(3) organization, and is willing to cede significant control to one or more public charities to qualify under the relationship tests. All three types of section 509(a)(3) organizations are subject to relationship tests, and a charitable DAO organized as a support organization would essentially

[77] *See Seasongood v. Commissioner*, 22 T.C. 671 (1954).

[78] Note that under reg. section 1.501(c)(4)-1(a)(2)(ii), a social welfare organization may qualify under section 501(c)(4) even though its activities are described in the action organization regulations if it otherwise meets the section 501(c)(4) qualification requirements.

need to put the officers, directors, or trustees of the supported section 501(c)(3) organization in control of the support organization. Pragmatically, that might be accomplished in the governing documents of the DAO, and by tokens layered with restrictions implementing the controls. Support organizations also face additional restrictions against accepting donations from certain persons and entities.[79]

A DAO operating for the primary purpose of carrying on a trade or business for profit could be structured serve as a feeder to 501(c)(3) charitable organizations. To be exempt from tax, a DAO wishing to qualify as a section 502 feeder organization to a charity with tax exemption under section 501(c) must carry on a trade or business in which substantially all the work is performed without compensated to service providers, is not classified UBIT under section 512, and pays all profits to the a section 501 tax exempt organization.[80] Qualification as a feeder organization under section 502 is unlikely to be appropriate in DAOs when incentive or award tokens are to be issued to service providers as compensation in exchange for services.[81] However, when a charitable DAO's tokens have no monetary value and are issued purely as governance or voting tokens, as badges or tokens of appreciation, and the DAO's leadership team is uncompensated, a nonprofit DAO could be categorized as a section 502 feeder organization if it is serving as the instrumentality of another tax-exempt organization.

DAOs as Business Leagues and Social Organizations

Some DAOs organized for nonprofit purposes might qualify as a tax-exempt section 501(c)(4) social welfare organization, section 501(c)(6) business league or trade organization, or section 501(c)(7) social club.

An organization exempt under section 501(c)(4), must be operated exclusively for the promotion of social welfare. 501(c)(4) could be a better fit than the section 501(c)(3) classification for some nonprofit DAOs that wish to advocate for some political causes because a section 501(c)(4) organization may conduct limited legislation lobbying activities — but more extensive than that of a section 501(c)(3) organization — without losing their tax exemption.[82] However, a section 501(c)(4) organization must notify donors that their

[79] *See* IRS Publication 557 (01/2023), Tax Exempt Status for your Organization.
[80] *See* section 502(a).
[81] *See* section 502(b)(2).
[82] *See* reg. section 1.501(c)(4)-1(a)(2)(ii).

contributions aren't tax deductible insofar as they are used for lobbying or political activities, and the organization will need to pay a proxy tax for any political or lobbying expenditures.[83] For a DAO issuing tokens for a 501(c)(4), similar restrictions on political activities, should be followed. As with their charitable DAO cousins, social welfare DAOS will typically want to restrict token issuance to voting and governance tokens to prevent UBTI and other parades of problems.

A business league, professional associations, and trade organizations organized as DAOs may qualify for tax exemption under section 501(c)(6). Unlike donations to a section 501(c)(3) or 501(c)(4) organization, the contributions to the section 501(c)(6) organization are not tax deductible but may be partially deductible as a business expense rather than a section 170 charitable contribution. However, a section 501(c)(6) organization cannot engage in the types of business regularly carried on for profit by offering services to members without being subject to UBIT. A section 501(c)(6) organization has no restriction on lobbying activities, though any portion of the dues, regardless of percentage, attributable to a section 501(c)(6) organization's lobbying expenditures is not allowed as a business deduction to the member, and the organization must notify members that the lobbying portion of dues is nondeductible.[84] Unlike charitable and social welfare DAOs, token issuances of a 501(c)(6) need not be restricted to voting and issuance, and tokens could be issued to league or association members to use in exchange for services from the league or association. For example, a DAO trade organization could provide restricted-use fungible tokens for use by members in enrolling to attend various continuing education put on by the trade organization. An additional opportunity for DAO business leagues is the potential to issue non-fungible tokens (NFTs), restricted to a single member, as evidence (and tracking) of membership, or perhaps the NFT could immutably track participation or education credits. However, the tokens should be restricted to ensure that no part of the organization's net earnings can inure to the benefit of a private shareholder or individual.

Social clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes — such as country clubs,

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[83]Section 162(e)(1)(A)(i); and section 162(e)(2); *see also* section 6033(e)(1(A)(ii).

[84]The organization is required to report the total amount of lobbying/political expenditures and total amount of dues allocable to such expenditures annually on Form 990, as well as report the amount to member; See also Section 162(e).

swim clubs, tennis clubs, running clubs, and fraternities — can qualify for tax exemption under section 501(c)(7). Under the gross receipts test applicable to section 501(c)(7) organizations, dues for the clubs must constitute most of their income, with limited exceptions for member and nonmember services.[85] As with business leagues and trade associations, fungible restricted tokens could be issued by a social club DAO for restricted use of the members to exchange for general or specific club services. DAO social clubs also hold the potential to issue member-specific, non-fungible tokens to track a member's sport performance, favorite foods, social metrics, or other participation in other club activities. As with business leagues, a DAO social club's tokens should be restricted to ensure that no part of the organization's net earnings can inure to the benefit of a private shareholder or individual.

A simultaneously beneficial and potentially hazardous aspect of organizing under section 501(c)(4) or 501(c)(6) is the option to self-declare as tax-exempt. However, a section 501(c)(4) organization must also notify the IRS of its intent to operate by filing Form 8976, "Notice of Intent to Operate Under Section 501(c)(4)," and, like a section 501(c)(3) organization, the DAO would need to be organized as a corporation. Self-declaration would bypass the usual section 501(c)(4) and (c)(6) requirement to file Form 1024, "Application for Recognition of Exemption Under Section 501(a) or Section 521 of the Internal Revenue Code," for tax-exemption determination. That could help a nonprofit DAO because the IRS may not know how to handle such an organization without first considering the issues in a technical advice memorandum. On the other hand, Form 1024 provides some safety against later IRS challenges to the organization.

Conclusion

DAOs with charitable or social purposes must navigate a myriad of tax classifications in both formation and operation and will either default into a tax status or need to select a tax status. A charitable or social purpose DAO's ultimate choice of tax status as a nonprofit, low-profit, or for-profit must be guided by the facts and circumstances of the DAO's intended constituency and the charitable or social purposes.

[85] *See* section 512(b)(3)