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Standing On the Shoulders of LLCs: The Tax Entity Status and Decentralized Autonomous Organizations

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STANDING ON THE SHOULDERS OF LLCS: TAX ENTITY STATUS AND DECENTRALIZED AUTONOMOUS ORGANIZATIONS

Samuel D. Brunson[*]

Since the formation of the first decentralized autonomous organization (DAO) in 2016, their use has exploded. Thousands of DAOs now try to take advantage of smart contracts to solve a problem that plagues business entities: the gulf between ownership and management. Armed with smart contracts and requiring token-holders to vote on any change in strategy, DAOs dispense with the management layer so necessary in traditional business entities. DAOs owe their existence to technology. Without blockchain, without cryptocurrency, and without smart contracts, there would be no DAOs. But they owe their explosiveness to something much more unexpected: Treasury regulations. In the wake of limited liability companies (LLCs), the last major new entity to emerge, Treasury created the check-the-box regulations. Prior to these regulations, a business entity had to determine whether it had more partnership or corporate characteristics to determine whether it would be taxed as a partnership or a corporation. LLCs did not fit comfortably into either category, so businesspeople did not adopt the form. When enacted, the check-the-box regulations allowed most business entities to decide how they wanted to be taxed and file an election with the Internal Revenue Service (IRS) for that treatment. This certainty futureproofed entity taxation. New business forms—including DAOs—no longer have to look like previous forms. They can choose their tax status. And without the impediment of taxes, people can—and did—adopt the DAO structure. Tax entity status comes with obligations, though. And while DAOs do not have to worry about their entity status, they also must

[*] Associate Dean for Faculty Research and Development and Georgia Reithal Professor of Law, Loyola University Chicago School of Law. I would like to thank Jeffrey L. Kwall and Omri Marian for their comments and recommendations and Loyola University Chicago School of Law for its generous research stipend. I would also like to thank Jamie Brunson for her support.

meet the obligations attendant to the status they choose. This Article discusses several of those obligations—obligations which, at times, run counter to the ethos of DAOs.

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I. INTRODUCTION

In November 2021, SpiceDAO acquired one of the few remaining copies of Alejandro Jodorowsky's pitchbook for a screen adaptation of *Dune*.[1] (The pitchbook was a book with concept art, costume design, a script, and storyboards for the proposed screen adaptation.[2]) The $2.9 million winning bid came from Soban Saqib, a 25-year-old nonfungible token (NFT) and cryptocurrency millionaire in California, who used nearly his whole net worth to acquire the pitchbook.[3]

A week later, he asked members of SpiceDAO, a decentralized autonomous organization (DAO) for $6 million; after taxes and legal fees, SpiceDAO would acquire the pitchbook from Saqib for $3.8 million.[4] Thousands of people across the internet—both friends of Saqib and people he did not know—contributed and the next day SpiceDAO had $12 million.[5]

To some extent, the speed of the internet and newly-minted crypto fortunes papered over Saqib's impulsiveness and lack of preparation. From the very beginning, he—and then SpiceDAO—radically overpaid for the pitchbook. Prior to Saqib's bid, appraisers estimated it would sell for $40,000.[6] While appraisal requires professional judgment and is ultimately more art than science,[7] paying 7,500 percent of the estimate suggests a breakdown in pricing somewhere.

And that breakdown is likely at the buyer side. SpiceDAO appears to have misunderstood what rights ownership of the

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[1] Edward Ongweso Jr., *SpiceDAO Roasted for Spending $3.8 Million on Jodorowsky's "Dune" Book*, VICE (Jan. 18, 2022, 12:59 PM), https://www.vice.com/en/article/xgda4a/spicedao-roasted-for-spending-dollar38-million-on-jodorowskys-dune-book.

[2] Germain Lussier, *How Jodorowsky's Dune Speaks to the Now (Beyond the Upcoming Film)*, GIZMODO (May 14, 2020, 3:45 PM), https://gizmodo.com/how-jodorowskys-dune-speaks-to-the-now-beyond-the-upco-1843416410.

[3] Aman Sethi, *How a Bunch of Crypto Nerds Liberated Jodorowsky's Bible for "Dune," The Greatest Film Never Made*, BUZZFEED NEWS (Dec. 9, 2021, 11:27 AM), https://www.buzzfeednews.com/article/amansethi/spicedao-dunedao-soby.

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *See, e.g.*, Kent Wetherell, *The New Burdens of Proof in Ad Valorem Tax Valuation Cases*, 25 FLA. ST. U. L. REV. 185, 227 n.314 (1998) (describing appraiser's valuations as professional judgments that are recognized by courts as "an art, not a science").

pitchbook granted to it. In January 2022, SpiceDAO made waves when it announced it had three plans for the pitchbook: to "[m]ake the book public (to the extent permitted by law)[,] [p]roduce an original animated limited series inspired by the book and sell it to a streaming service[, and] [s]upport derivative projects from the community."[8]

SpiceDAO's announcement "was quickly and widely ridiculed."[9] While Saqib and SpiceDAO acquired the physical pitchbook, they did not acquire the underlying intellectual property that would allow them to bring Jodorowsky's vision to fruition or create derivative works based in the pitchbook.[10] Copyright rights "are separate and distinct from rights in the material object in which the copyrighted work is embodied."[11] In its successful bid, SpiceDAO acquired the material object, not the copyright rights, though it proved unaware of these legal niceties.[12]

While SpiceDAO was not the first decentralized autonomous organization, its success in achieving its short-term goal of acquiring the pitchbook, combined with its naiveté in proceedings after it acquired the pitchbook, helped launch DAOs into the public consciousness.[13] That naiveté about legal uses of property it acquired likely extends into other legal regimes as well. Questions of the entity and tax status of DAOs will be increasingly important going forward, and in some cases, will require affirmative actions by DAOs of which DAO founders and investors—especially those

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[8] Spice DAO (@TheSpiceDAO), TWITTER (Jan. 15, 2022, 5:28 PM), https://twitter.com/TheSpiceDAO/status/1482404318347153413?s=20.

[9] Ongweso, *supra* note 1.

[10] *See id.* ("SpiceDAO doesn't actually own the rights to the contents of the book, just the physical copy.").

[11] T. Robert Rehm, Jr., *Navigating the Open Source Minefield: What's a Business to Do?*, 10 WAKE FOREST INTELL. PROP. L.J. 289, 293 (2010).

[12] *See* Ongweso, *supra* note 1 (discussing SpiceDAO's struggle to come to terms with the limitations of its legal rights to the pitchbook).

[13] At around the same time, another DAO—ConstitutionDAO—also entered the public consciousness as it raised tens of millions of dollars to bid on one of the few extant copies of the United States Constitution. Luc Olinga, *A Beginner's Guide to DAO, Killer of Hedge Funds and Corporate Structure*, THESTREET (Feb. 12, 2022), https://www.thestreet.com/investing/cryptocurrency/a-beginners-guide-to-dao-killer-of-hedge-funds-and-corporate-structure. Ultimately, hedge fund manager Ken Griffin outbid ConstitutionDAO, preventing it from having to figure out what to do with its copy of the Constitution and making less of a splash than the successful SpiceDAO. *Id.*

who, on a whim, are moving fast and breaking things[14]—are unaware.[15]

This Article proceeds as follows: Part II discusses various innovations in business entity law, especially in LLCs and DAOs. It describes where DAOs fit in the constellation of business entities and how they differ from traditional entities like corporations and partnerships.

Part III then compares the development and adoption of LLCs, a type of spiritual precursor to the DAO. In contrast to the rapid adoption of the DAO form, LLCs took decades to find general acceptance.[16] One significant reason was tax uncertainty.[17] Part III explains how, in response to the creation of LLCs, the Treasury Department promulgated truly elective tax entity status.

While this elective model of tax entity status was created in response to LLC pressures, Part IV demonstrates that in effect, the check-the-box election futureproofed the tax system. Because it is largely agnostic to the characteristics of an entity, the check-the-box regime allows for entity innovation and the adoption of new entities, including DAOs, because investors can know in advance how an entity will be treated for tax purposes.

Finally, Part V demonstrates that this futureproofing does not mean that DAOs have a free hand to do whatever they wish. Even an elective tax regime imposes obligations on taxpayers and business entities.[18] DAOs must comply with these tax obligations, even where the obligations are inconsistent with the DAO's ethos and goals.

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[14] In its early days, Facebook adopted the motto "mov[e] fast and break[] things." Alicia Solow-Niederman, *Administering Artificial Intelligence*, 93 S. CAL. L. REV. 633, 637 (2020). This ethos has permeated tech culture, often leading companies seeking to be (or be seen as) innovative to "bump up against, disregard, or even intentionally disobey laws in their quests to develop new technology." Elizabeth Pollman, *Private Company Lies*, 109 GEO. L.J. 353, 383 (2020).

[15] *See, e.g.*, *infra* note 257 and accompanying text (outlining how the anonymity structure of DAOs may be incompatible with required tax information returns).

[16] *See infra* notes 84–86 (discussing the slow emergence of LLCs).

[17] *See infra* notes 95–118 and accompanying text (outlining the uncertainty of tax treatment of LLCs at its inception and how this affected adoption of the LLC business format in its first years).

[18] *See, e.g.*, *infra* section V.B (discussing the disclosure requirements imposed on elective tax regimes).

II. DECENTRALIZED PERSONHOOD

The emergence of DAOs represents only the latest innovation in the world of business organizations. In 2010, Maryland and Vermont enacted the first legislation authorizing benefit corporations.[19] Two years earlier, Vermont became the first state to authorize the creation of low-profit limited liability companies (L3Cs).[20] The L3C itself is just an iteration of the LLC,[21] which is itself a relatively new form of business organization, authorized for the first time in Wyoming in 1977.[22] Within twenty years, all fifty states had enacted legislation authorizing LLCs.[23] As these new types of entities entered into the state law, they did not supplant older entities like corporations and partnerships; instead, they added more nuance to the world of business organizations.[24]

There are at least two reasons for this explosion of business organization types. The first is technological[25]: business organizations come with legal personhood.[26] Professor Shawn Bayern describes this legal personhood as a legal technology.[27] Legal personhood, he explains, allows a legal entity "to be recognized by law sufficiently to perform basic legal functions."[28] In

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[19] Steven Munch, Note, *Improving the Benefit Corporation: How Traditional Governance Mechanisms Can Enhance the Innovative New Business Form*, 7 NW. J.L. & SOC. POL'Y 170, 171 (2012).

[20] *See* Elizabeth Schmidt, *Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder*, 35 VT. L. REV. 163, 163 (2010) ("On April 30, 2008, Vermont recognized a new business entity, the low-profit limited liability company, also known as the L3C.").

[21] *See id.* ("An L3C is a for-profit organization, designed to retain the flexibility of a limited liability company (LLC), but with a primary motivation to achieve a charitable goal.").

[22] J. William Callison, *Federalism, Regulatory Competition, and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded*, 26 J. CORP. L. 951, 958 (2001).

[23] *See* Karin Schwindt, *Limited Liability Companies: Issues in Member Liability*, 44 UCLA L. REV. 1541, 1543–44 (1997) ("As of April 1997, all fifty states had LLC legislation in effect."). For a more robust discussion of the history of LLCs in American law, see *infra* section 0.A.

[24] *See infra* section III.A (discussing LLCs slow rise in popularity over the past two decades and its place in relation to corporations and partnerships in the world of business organizations).

[25] *See* Carla L. Reyes, *A Unified Theory of Code-Connected Contracts*, 46 J. CORP. L. 981, 983 (2021) ("[L]aw is a social technology—it is created, used, and applied within a broader social context.").

[26] *See* Gina-Gail S. Fletcher, *Deterring Algorithmic Manipulation*, 74 VAND. L. REV. 259, 300 (2021) ("[H]umans and business entities constitute 'persons' under the law . . . .").

[27] SHAWN BAYERN, AUTONOMOUS ORGANIZATIONS 47 (2021).

[28] *Id.*

spite of not being a natural person, a legal person can own property, enter into contracts, act as a principal and an agent, and can sue and be sued.[29] With the overlay of these rights, business organizations have the ability to operate in the broader economy.[30]

Endowed with the legal technology of personhood, business organizations provide an excellent vessel for allowing disparate people to pool their assets.[31] With this larger asset base, business entities can engage in endeavors that individuals could not do on their own.[32] It also allows individuals without the requisite knowledge or skills to engage in a particular business to nonetheless invest in and have financial exposure to that business.[33]

DAOs share critical similarities with more-traditional business entities such as corporations, partnerships, and limited liability companies (LLCs). Like other business entities, a DAO allows a disparate group of people to pool their assets and engage in resource-intensive endeavors that would be difficult for a single person to fund or manage.[34] This pooling of assets also allows them

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[29] *Id.* The Supreme Court has taken an expansive view of the rights associated with legal personhood, including recognizing some entities as having speech and religious rights. *See* Citizens United v. Fed. Election Comm'n, 558 U.S. 310, 319 (2010) ("The Government may regulate corporate political speech through disclaimer and disclosure requirements, but it may not suppress that speech altogether."). Scott W. Gaylord, *For-Profit Corporations, Free Exercise, and the HHS Mandate*, 91 WASH. U. L. REV. 589, 613–14 (2014) (discussing corporate constitutional rights in light of the Supreme Court's decision in *Citizens United*, which held that corporations may "exercise religion as well as speech"). While interesting and contentious, the question of whether business organizations possess these non-business rights generally associated with natural persons is beyond the scope of this Article.

[30] *See, e.g.*, Carla L. Reyes, *Autonomous Corporate Personhood*, 96 WASH. L. REV. 1453, 1495 (2021) (explaining by example how "Amazon enjoys a certain persona" that "[w]ields significant levels of economic and social power" because it is thought of as a "real entity acquiring real power and causing real impacts in society").

[31] *See* Ofer Eldar & Andrew Verstein, *The Enduring Distinction Between Business Entities and Security Interests*, 92 S. CAL. L. REV. 213, 215–16 (2019) (discussing "[t]he creative use of entities to pool assets").

[32] *See id.* (identifying some of these endeavors and the interplay between sponsor corporations and creditors).

[33] *See id.* at 227–28 (discussing how creditors may lack experience but are still an important part of a business model). For instance, I have no knowledge of how to build an electric car and no skills that would be particularly useful in building one. But even without that knowledge and skill, I can purchase Tesla stock and receive financial exposure to the electric car market.

[34] *See, e.g.*, Olinga, *supra* note 13 ("A group of crypto enthusiasts last November shocked the world by raising tens of millions of dollars to buy a rare version of the U.S. Constitution.").

to pool expertise so that not every participant has to be intimately aware of the details of the business.

But DAOs differ in at least one important respect: the attempt to eliminate the gap between ownership and control. Corporations illustrate the extremes of this gap. Corporate shareholders do not make strategic and business decisions on behalf of the corporation (at least, not in their capacity as shareholders).[35] Rather, shareholders' governance rights are limited to voting on the corporation's board of directors and a handful of other high-level questions.[36] The board of directors makes corporation decisions.[37]

General partnerships feature a less-explicit divide between ownership and management. In a general partnership, unless the partnership agreement specifies otherwise, each partner gets one vote on questions of governance and, where the partners disagree, the majority governs.[38] LLCs split the difference with the option of being member-managed (the general partnership model) or manager-managed (the corporate model).[39]

Recognizing that managers' incentives often differ from the owners' best interest, both law and practice have worked to align managers' incentives with the owners'. Business entity law imposes fiduciary obligations on managers; these fiduciary duties require managers to exercise a baseline level of care as they manage the business entity and impose legal and financial penalties when managers profit at the expense of owners.[40] And businesses themselves have attempted to align the incentives of managers in extra-legal ways as well. For instance, many corporations pay a portion of directors' compensation in shares of or options on the

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[35] *See Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles and Responsibilities*, 65 BUS. LAW. 107, 113 (2009) ("Control of, and responsibility for, the business and affairs of the corporation is vested in the board of directors, rather than in the company's shareholders.").

[36] *Id.*

[37] *Id.*

[38] *See, e.g.*, 805 ILL. COMP. STAT. ANN. § 206/401(f) (West 2003) ("Each partner has equal rights in the management and conduct of the partnership business.").

[39] *See, e.g.*, N.Y. LTD. LIAB. CO. LAW § 401 (McKinney 1994) ("Unless the articles of organization provides for management of the limited liability company by a manager or managers or a class or classes of managers, management of the limited liability company shall be vested in its members who shall manage the limited liability company . . . .").

[40] *See* Kelli A. Alces, *Strategic Governance*, 50 ARIZ. L. REV. 1053, 1060 (2008) (describing generally the solutions corporate law offers to the traditional agency problems).

corporation's stock.[41] Some corporations even require directors to hold a certain minimum amount of corporate stock.[42] In both cases, the underlying justification for the respective corporate policy is that if directors are also equity owners of the corporation, they will act in the best interest of the shareholders.[43]

While the divide between ownership and management is not as stark as the general partnership governance model divide, even there the divide exists. While all partners get an equal vote on governance questions, where there is disagreement, some partners will not get their preference.[44] Where any given person who operated a business on their own could enjoy unfettered management discretion, once there are multiple owners, that discretion faces some degree of limitation.[45]

DAOs aim to eliminate this disconnect between ownership and management.[46] To do so they eliminate the management layer of business organizations entirely.[47] They eliminate that management layer in two ways. The first is by following the general partnership model. Each investor in a DAO gets a vote on what the DAO will do; investors vote on the blockchain so that the vote is open and transparent.[48]

Second, to move DAO governance away from even the disintermediation of general partnership governance, though,

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[41] *See* Matthew A. Melone, *Are Compensatory Stock Options Worth Reforming?*, 38 GONZ. L. REV. 535, 539 (2002) (noting that stock options played the most significant role in the tripling of executive compensation between from 1992 to 2000).

[42] *See* Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 GA. ST. U. L. REV. 251, 302–03 (2005) (describing so called good governance practices and evidence supporting the practices' value).

[43] *See, e.g.*, Melone, *supra* note 41, at 538 ("Through equity-based compensation, management becomes part of the shareholder base, or is compensated as if it were, thereby more closely aligning management and shareholder objectives.").

[44] *See* REVISED UNIF. P'SHIP ACT § 401(j) (2021) ("A difference arising as to a matter in the ordinary course of business of a partnership may be decided by a majority of the partners. An act outside the ordinary course of business of a partnership and an amendment to the partnership agreement may be undertaken only with the consent of all of the partners.").

[45] *Id.*

[46] *See* Kyung Taeck Minn, Note, *Towards Enhanced Oversight of "Self-Governing" Decentralized Autonomous Organizations: Case Study of The DAO and Its Shortcomings*, 9 NYU J. INTELL. PROP. & ENT. L. 139, 148 (2019) ("Aware of the principal-agent problem, the architects of an early version of a DAO smart contract sought to circumvent the problem by eliminating, or, at least, diminishing the powers of, the problem's cause, the manager.").

[47] *See id.* (describing DAO's majority vote mechanism).

[48] *See id.* at 150–51 (detailing the functioning of DAO governance mechanisms).

DAOs generally remove even this type of owner-management. For the most part, DAO management is *autonomous*.[49] DAO decisions are guided by smart contracts and algorithms.[50] The only time and the only way DAO investors can make management decisions—decisions that could go against the desires of some investors—is to vote to change the underlying smart contracts, a vote which could require unanimity.[51] As a result of this autonomy, DAO investors theoretically understand before they invest what the DAO will do.[52] Moreover, where decisions occur that cause the DAO to change its fundamental goals and strategies, investors can see in the blockchain what those changes are and how they occurred.[53]

While DAOs share some characteristics with both corporations and LLCs, by default they can be neither for legal purposes. To form a corporation or an LLC, founders must file documentation with the state in which they organize the entity and pay certain fees.[54] It is certainly possible for a DAO to take the steps necessary to create some kind of limited liability entity, but taking those steps—even if the steps are easy and inexpensive—may not be worth the trouble for the types of endeavors in which DAOs intend to engage.[55]

In contrast to corporations and LLCs and other formal business entities that provide limited liability to owners, creating a DAO requires no formal action with the state. Instead of filing with a

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[49] *See id.* at 150 ("The DAO was to be autonomous . . . .").

[50] *See* Wulf A. Kaal, *Blockchain-Based Corporate Governance*, 4 STAN. J. BLOCKCHAIN L. & POL'Y 3, 6 (2021) (describing the "near error free" coordination offered by smart contracts and blockchain technology).

[51] *See* William K. Pao, Scott Sugino & Wenting Yu, *What the DAO? Breaking Down the Latest Blockchain Craze* (Mar. 8, 2022), https://www.omm.com/resources/alerts-and-publications/alerts/dao-latest-blockchain-craze (describing how DAO token holders can change smart contracts).

[52] *See id.* (noting when someone joins a DAO, they agree to the already coded smart contract).

[53] *See* Minn, *supra* note 46, at 152 (noting the DAO's purpose was to provide an "immutable transaction record").

[54] *See* D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES 99, 174 (4th ed. 2019) (outlining the formation processes for LLCs and corporations).

[55] *See* Carla L. Reyes, *If Rockefeller Were a Coder*, 87 GEO. WASH. L. REV. 373, 400–01 (2019) [hereinafter Reyes, *If Rockefeller Were a Coder*] (explaining that the creation of some limited liability entity may be futile for DAOs because incorporation or formation of an LLC does little to cover them from programming error tort liability and corporate law requirements still require "natural persons" as shareholders, which would prevent the incorporation of a completely autonomous DAO).

state, DAOs are formed by "layering programs called 'smart contracts' on top of a cryptocurrency."[56] Smart contracts are computer code that run on distributed ledger technology protocols.[57] Generally speaking, smart contracts exercise some type of control over assets recorded on a blockchain and, when they receive certain specified data, they take some kind of action and record that action on the blockchain ledger.[58] Essentially, then, as a result of their programming, "[smart contracts] are self-executing."[59] With self-executing contracts at the center of a DAO, its governance is both decentralized, because it cannot be run by a single person or group of people, and autonomous, because it can act for itself.[60]

The layered smart contracts provide an underlying set of rules for the DAO.[61] Then, to fund the DAO, its founders sell tokens online.[62] These tokens provide holders with certain rights, including especially the right to vote for projects the tokenholders want the DAO to fund.[63] Once the requisite number of tokenholders vote to approve a particular endeavor, the DAO transfers its cryptocurrency to a smart contract that governs the project they have voted on.[64]

Under current law, then, most DAOs are likely general partnerships unless the DAO founders choose to take the steps necessary to form an entity with limited liability.[65] Forming a

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[56] Usha R. Rodrigues, *Law and the Blockchain*, 104 IOWA L. REV. 679, 680 (2019).

[57] *See* Reyes, *If Rockefeller Were a Coder*, *supra* note 55, at 383 (offering a brief overview of smart contract technology).

[58] *See id.* at 383–84 (listing the characteristics inherent in most smart contracts).

[59] Rodrigues, *supra* note 56, at 680.

[60] *See id* (noting the novelty of this simultaneously decentralized and autonomous "organization"). Professor Bayern analogizes this type of smart contract-guided governance to a vending machine: when I put money into a vending machine and push a button, the vending machine gives me what I purchased even though there is no legal person with whom I contract. BAYERN, *supra* note 27, at 20.

[61] *See* Rodrigues, *supra* note 56, at 681 ("These smart contracts enabled . . . DAO[s] to implement fairly sophisticated governance and exit rules . . . .").

[62] *See* Georgios Dimitropoulos, *The Law of Blockchain*, 95 WASH. L. REV. 1117, 1136 (2020) (explaining that tokens are sold to stakeholders of DAOs).

[63] *See id.* (highlighting voting rights as one of the benefits of buying DAO-provided tokens).

[64] *See* Reyes, *If Rockefeller Were a Coder*, *supra* note 55, at 388 (explaining the rights of tokenholders in selecting the projects governed by smart contracts).

[65] *See* Aaron Wright, *The Rise of Decentralized Autonomous Organizations: Opportunities and Challenges*, 4 STAN. J. BLOCKCHAIN L. & POL'Y 152, 167 (2021) ("[I]n the U.S., DAOs formed for the purpose of making a profit likely would be deemed a 'general partnership' and

partnership does not require partners to take any formal steps or pay any money to the state. Rather, when two or more people as co-owners operate a business for profit, they have formed a partnership.[66] It does not matter whether they *intended* to form a partnership.[67] What matters is their intent to carry on a business as co-owners.[68] Because the intent requirement attaches to carrying on business and not to forming a partnership, individuals can inadvertently form a partnership.[69]

As a normative matter, placing DAOs into the *general partnership* category may not be ideal. While some aspects of DAOs are good fits for partnerships, others are not. For instance, because DAOs lack any type of formal entity creation, and because founders and investors find each other online, it is not immediately obvious what jurisdiction's laws should govern a DAO-as-general-partnership.[70] And general partnership come with real downsides, including not only some degree of separation between ownership and control, but also joint and several liability of the partners for partnership debts and obligations.[71] Professor Carla Reyes, for example, argues that DAOs should be structured as business trusts, an entity choice that avoids the incongruities between DAOs and corporations, LLCs, and partnerships.[72]

While most DAOs likely default as general partnerships for state law purposes, in some circumstances DAOs may be joint ventures instead. While joint ventures are similar to partnerships, they are not identical: unlike a partnership, a "joint venture is not

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consequently lack the ability to shield members' assets if the organization injures a third-party or is unable to pay its creditors.").

[66] *See* REVISED UNIF. P'SHIP ACT § 101(6) (2022) (providing an operational definition for the term "partnership").

[67] *See, e.g.*, Hillman v. Cannon, No. 11-0367, 2011 WL 6670657, at *3 (Iowa Ct. App. Dec. 21, 2011) (unpublished table decision) (explaining that intent to form a partnership is irrelevant to the court's analysis).

[68] *See id.* (explaining that the court examines a person's intent to be business co-owners).

[69] *See id.* (noting that persons "may inadvertently create a partnership despite their expressed subjective intention not to do so").

[70] *See, e.g.*, Adam J. Kolber, *Not-So-Smart Blockchain Contracts and Artificial Responsibility*, 21 STAN. TECH. L. REV. 198, 214–15 (2018) (discussing novel legal questions created by DAOs).

[71] *See, e.g.*, Reyes, *If Rockefeller Were a Coder*, *supra* note 55, at 373 (noting some critiques of DAO general partnerships).

[72] *See id.* at 406 (detailing the author's argument that DAOs should be structured as business trusts).

necessarily a separate entity with a separate legal existence."[73] While the line between partnership and joint venture is fuzzy and indeterminate, at least on the margins, in general, a joint venture has a more limited scope by focusing on a single transaction and with a limited expected life.[74] But while state law may treat some DAOs as joint ventures rather than general partnerships, the distinction makes little difference practically. Common law also imposes joint and several liability on joint venturers (unless a state has statutorily overruled the common law).[75] In fact, in most ways "a joint venture is governed by the same rules as a partnership."[76] To the extent partnership rules represent an uncomfortable overlay on DAOs, joint venture rules represent a similarly uncomfortable fit.

III. LIMITED LIABILITY COMPANIES AND THE STATE OF THE ART

While scholars have explored both the normative and descriptive question of DAO entity type for state law purposes, they have given limited thought to how the tax law characterizes a DAO.[77] This oversight is understandable. DAOs are new and have only begun to enter into the public consciousness.[78] Moreover, the tax treatment of DAOs is largely self-evident. And perhaps most importantly, the

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[73] *In re* Webb, 474 B.R. 891, 894 (Bankr. E.D. Ark. 2012), *aff'd*, 742 F.3d 824 (8th Cir. 2014).

[74] *See* Laila Metjahic, Note, *Deconstructing the DAO: The Need for Legal Recognition and the Application of Securities Laws to Decentralized Organizations*, 39 CARDOZO L. REV. 1533, 1560 (2018) ("Many courts have held that the major distinction between a joint venture and a partnership is that a joint venture relates to a single transaction or enterprise and a partnership relates to a continuing business relationship.").

[75] *See* Sloan v. Law Off. Oscar C. Gonzalez, Inc., 479 S.W.3d 833, 835 (Tex. 2016) (noting that common law controls joint and several liability).

[76] Thompson v. Thompson, 500 S.W.2d 203, 209 (Tex. Civ. App. 1973).

[77] There is one notable exception to this limited thought: In 2018, Professor David J. Shakow published an article in Tax Notes exploring the tax treatment of DAOs. *See* David J. Shakow, *The Tao of the DAO: Taxing an Entity That Lives on a Blockchain*, 160 TAX NOTES 929, 930 (2018) (discussing a lack of scholarship about DAOs' interaction with the American tax system). In his article, Professor Shakow comes to the same conclusion I do in this Article: By default, DAOs are treated as partnership for U.S. federal income tax purposes. *See id.* at 934–38 (reasoning that DAOs are partnerships for tax purposes by discussing regulations, case law, and practical implications). In this Article, I do a parallel descriptive analysis, with some differences. But I also make normative claims that build on the description of positive law and expand the scope of what it means to DAO tokenholders to be partners in an entity treated as a partnership for tax purposes.

[78] *See id.* at 929 (describing how DAOs first emerged around 2016).

history of cryptocurrencies includes a significant strain of anti-tax activism.[79] While the cryptocurrency market has matured and shed some of its early anti-tax views,[80] it continues to have an ethos that the traditional tax rules do not fit the world of blockchain.[81]

The traditional tax rules do, however, fit DAOs remarkably well. In large part, their ability to encompass a new and novel entity is the result of the Treasury Department futureproofing the tax classification of entities in the wake of LLCs.[82]

In fact, in many ways, LLCs were an explicit precursor to DAOs. When initially conceived, LLCs did not fit comfortably into either corporate or partnership entity status. But LLCs emerged in an era before Treasury futureproofed entity status, and the lack of certainty about the tax entity status of LLCs significantly impeded their growth and adoption. Looking at the history of LLCs provides insight both into how the development of the current tax entity status was created for LLCs and how that certainty could allow DAOs to grow in a manner that was unimaginable in the 1970s when the first states enacted legislation authorizing the creation of LLCs.

A. HISTORY OF LLCS

In the late 1970s, LLCs occupied essentially the same place in the constellation of business organizations that DAOs occupy today. As a new entity, it was neither a corporation nor a partnership.[83] In many ways, it combined the best of both: LLCs had the limited

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[79] *See* David Z. Morris, *How Tax Protestors Set Off the Bitcoin Revolution*, COINDESK (Feb. 28, 2022, 3:20 PM) https://www.coindesk.com/layer2/taxweek/2022/02/28/how-tax-protesters-set-off-the-bitcoin-revolution/ ("Those anti-tax and anti-government attitudes were a major factor in perhaps the single most important moment in the brief history of cryptocurrency.").

[80] *See id.* (discussing that anti-tax sentiments have declined since the 2011 New Hampshire-based Free State Project).

[81] For instance, in response to proposed information reporting rules that would apply to cryptocurrency, some cryptocurrency supporters tried "to create the impression that this innovative technology is somehow ill-suited to meeting the tax-reporting requirements that apply to traditional banks and brokerages." Alexis Goldstein, *Crypto Doesn't Have to Enable Tax Cheats*, BLOOMBERG OP. (Aug. 26, 2021, 7:00 AM) https://www.bloomberg.com/opinion/articles/2021-08-26/crypto-doesn-t-have-to-enable-tax-cheats (arguing that technology does not present a barrier to complying with tax laws).

[82] *See infra* notes 138–146 (discussing the evolution of LLC tax classification over time).

[83] *See* Callison, *supra* note 22, at 958–60 (outlining the inception of the LLC and how it did not fit comfortably into the category of either a corporation or a partnership).

liability afforded to corporations combined with the flexibility (and, founders hoped, the tax treatment) of partnerships.[84]

And yet for all their advantages, businesses proved slow to take advantage of the LLC form. While Wyoming passed the first LLC statute in 1977,[85] it took another five years until Florida became the second state to authorize LLCs.[86] And Florida's LLC statute proved to be "the business form version of an Edsel. Nobody bought it."[87] By contrast, while it is hard to get an accurate count of the number of DAOs that exist, by 2021—five years after the launch of the first DAO—there were at least 4,000 DAOs that collectively held assets worth over $13 billion.[88]

Why did LLCs face such a difficult battle to gain acceptance? In large part, because of tax uncertainty.[89] In 1975, Hamilton Brothers Oil tried, unsuccessfully, to convince Alaska to enact a statute authorizing LLCs, a new entity form in the U.S.[90] It modeled its proposed LLC after foreign limited liability entities it used, and particularly after the Panamanian *limitada* with which it had extensive experience.[91]

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[84] *See* Susan Pace Hamill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, *in* BUS. TAX STORIES 295, 295–96 (2005) [hereinafter Hamill, *The Story of LLCs*] ("The LLC promised . . . the limited liability of corporations and the favorable tax treatment of partnerships."); McNamee v. Dep't of Treasury, 488 F.3d 100, 107 (2d Cir. 2007) (comparing LLCs to partnerships because of their similar features regarding limited personal liability and management flexibility).

[85] *See supra* note 22 and accompanying text.

[86] *See* Barbara Ann Banoff, *Company Governance Under Florida's Limited Liability Company Act*, 30 FLA. ST. U. L. REV. 53, 55 n.13 (2002) (noting that in 1982, Florida became the second state to adopt an LLC statute); FLA. STAT. §§ 608.401–608.514 (1982) (authorizing the LLC).

[87] Banoff, *supra* note 86, at 55 n.13.

[88] *See* Eric Lipton & Ephrat Livni, *Reality Intrudes on a Utopian Crypto Vision*, N.Y. TIMES (Mar. 8, 2022) https://www.nytimes.com/2022/03/08/us/politics/cryptocurrency-dao.html (addressing concerns raised by the DOA's internal framework and lack of regulation).

[89] *See generally* Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459 (1998) [hereinafter Hamill, *The Origins*] (discussing the origins of the LLC and its turbulent relationship with and treatment by the IRS).

[90] *See id.* at 1463 (discussing the birth of the LLC and how it was created by innovative professionals, like the Hamilton Brothers Oil Company, searching for "solutions to meet client needs").

[91] *See id.* at 1463–64 (explaining why Hamilton Brothers Oil Company created and proposed a new model to the Alaskan legislature that resembled a foreign limitada rather than a domestic model).

Limitadas provided two benefits for oil and gas companies: members had limited liability and for U.S. tax purposes, oil companies felt comfortable classifying them as partnerships, with the advantageous flow-through taxation.[92] Using these foreign entities provided some administrative difficulties, though, and with no equivalent U.S. entity, Hamilton Brothers and other limitada owners worried that courts would not recognize or respect their limited liability.[93]

Ultimately, though, after two attempts at passing a bill authorizing LLCs, the Alaskan legislature failed to enact the legislation.[94] Hamilton Brothers proceeded to take an identical bill to Wyoming, which successfully enacted it—without any complications—in 1977.[95]

But passing authorizing legislation was only the first step in the widespread adoption of LLCs. The question of how the federal income tax would classify them proved equally important.[96] Investors wanted to ensure that the tax law would treat LLCs as partnerships.[97] While partnerships are business entities, they are not taxpayers.[98] Rather, each partner pays taxes on their distributive share of partnership income in the year the partnership receives the income, whether or not the partnership distributes that income to its partners.[99] This so-called pass-through taxation is advantageous to partners because it ensures that partnership

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[92] *See id.* at 1463 ("[L]imitadas provided direct limited liability and the ability to secure partnership for U.S. income tax purposes.").

[93] *See id.* at 1464 ("The Hamilton Brothers Oil Company soon found that Panamanian limitadas . . . created uncertainty concerning the degree that U.S. courts would respect the limited liability characteristic.").

[94] *Id.* at 1465.

[95] *Id.*

[96] *See id.* at 1464–65 (discussing the conversation regarding tax treatment of LLCs).

[97] *See* Martha W. Jordan, *Pennsylvania's Limited Liability Company Act Raises Taxing Questions*, 69 TEMP. L. REV. 703, 706 (1996) ("Most important to investors, an LLC can be structured so that it qualifies for the preferential tax treatment available to partnerships.").

[98] *See* I.R.C. § 701 ("A partnership as such shall not be subject to the income tax imposed by this chapter.").

[99] *See id.* § 702(a)(1) ("In determining his income tax, each partner shall take into account separately his distributive share of the partnership's . . . gains and losses from sales or exchanges of capital assets held for not more than 1 year . . . .").

income faces only one level of taxation as opposed to the two levels of taxation imposed on corporate income.[100]

Unlike partnership income, corporate income faces two levels of taxation.[101] First, the corporation pays taxes on its income when it earns that income.[102] Then, when it pays that income to shareholders in the form of dividends, its shareholders have to pay taxes on the dividends they receive.[103] The advantages of pass-through taxation over corporate taxation would have been particularly salient in the late 1970s and early 1980s, when corporations faced a top marginal tax rate of forty-six percent[104] and individuals a top marginal tax rate of seventy percent.[105] If a corporation earned $200,000 in 1980, it would owe a corporate income tax of $72,750.[106] If it then paid a dividend of the remaining $127,250 to a shareholder or shareholders in the top marginal tax bracket, that shareholder or shareholders would pay taxes of $89,075, leaving them with $38,175 after taxes.[107] In 1980, the two levels of taxation took more than eighty percent of corporate earnings.[108]

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[100] *See* Shaun M. Klein, *Piercing the Veil of the Limited Liability Company, from Sure Bet to Long Shot:* Gallinger v. North Star Hospital Mutual Assurance, Ltd., 22 J. CORP. L. 131, 132 n.3 (1996) (discussing the tax structure of partnerships).

[101] *See* I.R.C. § 1361 (defining the S corporation); *id.* § 1363 (discussing how shareholders can eliminate the second layer of corporate taxation for qualifying corporations by electing to treat the corporation as an S corporation).

[102] *See id.* § 11(a) ("A tax is hereby imposed for each taxable year on the taxable income of every corporation.").

[103] *See id.* § 61(a)(7) (declaring that dividends are taxable).

[104] *See Historical U.S. Federal Corporate Income Tax Rates & Brackets, 1909–2020*, TAX FOUND. (Aug. 24, 2021) [hereinafter *Historical Corporate Rates*], https://taxfoundation.org/historical-corporate-tax-rates-brackets/ (presenting corporate tax rates for the years 1909 to 2020).

[105] *See Historical U.S. Federal Individual Income Tax Rates & Brackets, 1862–2021*, TAX FOUND. (Aug. 24, 2021) [hereinafter *Historical Individual Rates*], https://taxfoundation.org/historical-income-tax-rates-brackets/ (presenting individual income tax rates for the years 1862 to 2021).

[106] The effective rate—just over thirty-six percent—is less than the marginal rate because corporations in 1980 faced moderately progressive income tax rates on their first $100,000 of income. *Historical Corporate Rates*, *supra* note 104.

[107] Like corporations, individuals face progressive marginal tax rates. *See Historical Individual Rates*, *supra* note 105 (showing the progressive marginal tax rates for individuals). But if an individual's other income already put them in the top marginal tax bracket, the full amount of their dividend would be taxed at the top rate. For simplicity's sake, then, this example assumes all shareholders are already in the top marginal tax bracket.

[108] *Id.*

The single level of partnership taxation was, by comparison, much less confiscatory. If a partner's share of partnership income was $200,000, the partnership itself would pay no taxes. The top-bracket partner would pay taxes at their seventy-percent marginal rate, paying a still-substantial $140,000 of taxes. After taxes, though, they would have a distributive share of $60,000, about fifty-percent more after taxes than the corporate shareholder's $38,175.[109]

The difference between corporate and partnership tax is less pronounced today. The corporate income tax rate has fallen to twenty-one percent,[110] while the top individual income tax rate will be thirty-seven percent until 2026.[111] In addition, dividends are generally taxable at preferential long-term capital gain rates.[112] The top long-term capital gain rate is currently 20 percent plus a 3.8-percent net investment income tax.[113] Thus, on $200,000 of corporate income, a corporation would pay taxes of $42,000. When it passed the remaining $158,000 through to shareholders in the top marginal tax bracket, they would pay an additional $37,604, leaving them with $120,396 after taxes. If the income had been earned by a partnership, the partners would pay $74,000 in taxes, leaving them with $126,000. Still, while the delta between shareholders and partners is narrower, it continues to exist.

It was critically important to the LLC form that LLCs qualify for partnership taxation.[114] But it was initially unclear whether the Internal Revenue Service (IRS) would recognize them as partnerships. When Wyoming passed its LLC legislation, Treasury regulations determined whether an unincorporated entity would be treated as a partnership or a corporation by looking at four characteristics.[115] Under the regulations, if an entity had three of these four corporate-like characteristics—"free transferability of

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[109] Also, if the corporation had more than $200,000, it would have paid a higher effective rate of taxes. With $2 million in income, it would have paid $900,750 in taxes, for an effective rate of forty-five percent.

[110] I.R.C. § 11(b).

[111] *Id.* § 1(j).

[112] *Id.*§ 1(h)(11).

[113] *Id.* §§ 1(h)(1)(D), 1411(a)(1).

[114] *See* Hamill, *The Origins*, *supra* note 89, at 1461 (discussing how LLCs sought "the benefits of partnership taxation").

[115] Hamill, *The Story of LLCs*, *supra* note 84, at 294–95.

interests, continuity of life, centralized management and limited liability"—the tax law would treat it as a corporation.[116]

The Wyoming law did not allow for free transferability of interests or continuity of life.[117] But even though that should have qualified Wyoming LLCs as tax partnerships, it took until 1980 for the IRS to issue a private letter ruling granting an LLC that status.[118] While private letter rulings are not precedential and apply only to the taxpayer who requested the ruling, its issuance signaled that the IRS was willing to view LLCs as tax partnerships.[119]

The IRS's willingness to grant a private letter ruling to a Wyoming LLC did not assuage taxpayers' concerns, though. The day before it issued the private letter ruling, the IRS issued proposed regulations that would have treated any business organization with limited liability—including an LLC—as a corporation for tax purposes.[120] Three years later, after a storm of critical comments, the IRS withdrew the proposed regulations and announced that it would study the question of limited liability's effect on tax entity status.[121]

The IRS's withdrawal of its proposed regulation left the tax status of LLCs where it had been prior to 1980: ambiguous and uncertain. And in this morass of ambiguity and uncertainty, virtually nothing happened with LLCs. For the first ten years of

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[116] *Id.*

[117] *Id.*

[118] *Id.*; *see* I.R.S. Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980) ("Since it will lack continuity of life and free transferability of interests, Z [the LLC] will not have a preponderance of corporate characteristics. Therefore, Z will be treated as a partnership for Federal income tax purposes and not as an association taxable as a corporation."). It was critical to this analysis that, under Wyoming law at the time, an LLC would terminate on, among other triggers, the death or dissociation of a member. *Id.*

[119] The Federal Court of Claims explained that private letter rulings have no precedential value. Vons Cos. v. United States, 51 Fed. Cl. 1, 12 (2001) (noting that such memoranda "may not be used or cited as precedent"). A private letter ruling does, however, "indicat[e] the IRS interpretation of its own regulations and procedures." *Id.*

[120] *See* Classification of Limited Liability Companies, 45 Fed. Reg. 75,709 (Nov. 17, 1980) (proposing that any business organization with limited liability will be treated as a corporation).

[121] *See* Hamill, *The Story of LLCs*, *supra* note 84, at 296 (stating that the IRS withdrew the proposed regulations).

their existence, fewer than 100 businesses applied for LLC status and only Florida followed Wyoming in enacting LLC legislation.[122]

In 1988—more than ten years after Wyoming had authorized the first U.S. LLCs—the IRS issued a formal ruling on their tax status.[123] In its ruling, the IRS held that a Wyoming LLC qualified for partnership tax treatment.[124] In coming to this conclusion, it adopted the analysis of its eight-year-old private letter ruling: an entity with two or fewer of the four corporate characteristics would qualify as a partnership for tax purposes.[125] Because Wyoming LLCs lacked continuity of life and free transferability of interests, under the IRS's framework they qualified for pass-through tax treatment.[126]

In the wake of the IRS's formal ruling, states "slowly and cautiously started to enact legislation allowing for the formation of LLCs."[127] Two years later, Kansas and Colorado became the third and fourth states to enact LLC statutes.[128] In 1991, four more states enacted LLC legislation and about 1,700 businesses registered as LLCs.[129]

While the use of LLCs was clearly increasing with the IRS's liberalization and codification of the standards for partnership taxation, the LLC form still faced significant impediments to widespread adoption. The IRS, after all, still held significant power over the future treatment of LLCs as partnerships.[130] Moreover, to qualify as a tax partnership, an LLC had to meet the IRS's

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[122] *See id.* ("Less than one hundred businesses actually filed as LLCs and only Florida followed suit be enacting a LLC statute in 1982.").

[123] *See id.* ("Wyoming LLCs would be taxed as partnerships despite possessing the corporate characteristic of limited liability.").

[124] *See* Rev. Rul. 88-76, 1988-2 C.B. 360, 1988-38 IRB WL 546801 (stating that a Wyoming LLC "is classified as a partnership for federal tax purposes").

[125] *See id.* ("[I]f an unincorporated organization possesses more corporate characteristics than noncorporate characteristics, it constitutes an association taxable as a corporation.").

[126] *See id.* (stating that Wyoming LLCs did not have more corporate characteristics than not).

[127] Hamill, *The Origins*, *supra* note 90, at 1470.

[128] *See id.* ("It took until 1990—the year Colorado and Kansas both passed LLC statutes—for any states to step forward and recognize the creation of LLCs in light of the IRS's revenue ruling.").

[129] *See id.* at 1473–74 ("[F]our more states enacted LLC statutes . . . .").

[130] *See id.* at 1473 ("[T]he IRS, though its ability to interpret how the partnership classification regulations applied to LLCs, still possessed a great deal of power over the future viability of LLCs.").

draconian restriction on transferability.[131] If partnership taxation meant that members could only transfer their membership interests with the unanimous consent of other members, LLCs would remain an impracticable entity for doing business.[132]

The American Bar Association's Section on Taxation tried to push the IRS to "apply the partnership classification rules less restrictively" than it had applied them in its revenue ruling of 1988.[133] But, while the IRS did not immediately react, between 1992 and 1996, LLCs began to pick up steam.[134] By 1996, all fifty states had enacted LLC legislation.[135] And as the number of states permitting LLCs increased, so did the number of LLCs. By 1995, 119,000 LLCs filed partnership tax returns.[136]

As the LLC form gained more popularity and acceptance, so did the IRS's willingness to change its classification rules. In 1995, the IRS announced that it intended to change its entity classification standards.[137] While its previous regulations were "based on the historical differences under local law between partnerships and corporations," the new LLC laws provided for both partnership and corporate characteristics, "narrowing considerably the traditional distinctions between corporations and partnerships."[138] In response, the IRS proposed an entity regime in which owners of unincorporated entities could explicitly elect to treat the entities as partnerships for tax purposes.[139]

This elective regime was not tremendously far from the previous regime. Under the regulations that existed prior to the IRS's announcement, entities could effectively elect partnership

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[131] *See id.* (insisting on the requirement of "unanimous consent to transfer a complete interest").

[132] *See id.* (discussing how business lawyers recognized that LLCs "could not be utilized on any large scale" with these restrictions on transferability).

[133] *Id.* at 1474.

[134] *Id.* at 1479–83.

[135] Hamill, *The Story of LLCs*, *supra* note 84, at 297.

[136] BILL PRATT & MAUREEN PARSONS, INTERNAL REVENUE SERV., STATISTICS OF INCOME BULLETIN: FALL 2003, PARTNERSHIP RETURNS FOR 2001, at 54 (2003), https://www.irs.gov/pub/irs-soi/01partnr.pdf

[137] *See* I.R.S. Notice 95-14, 1995-14 I.R.B. 7 [hereinafter IRS Notice] (requesting comments as the IRS considered "simplifying the classification regulations to allow taxpayers to treat domestic unincorporated business organizations as partnership or as associations on an elective basis").

[138] *Id.*

[139] *Id.*

treatment by designing the entity in a way that it lacked two of the four necessary corporate characteristics.[140] But the IRS recognized that both taxpayers and the IRS had to spend significant resources determining the appropriate classification of LLCs and similar entities.[141] Moreover, because of the cost and effort in designing the entity so that it qualified as a partnership, the effective electivity of unincorporated entities favored wealthy and sophisticated taxpayers. Smaller organizations, the IRS acknowledged, "may not have sufficient resources and expertise to apply the current classification regulations to achieve the tax classification they desire."[142]

With widespread public support for this new elective approach, about a year after it announced the change, the IRS issued proposed regulations that encapsulated this new elective approach.[143] Months later, in December 1996, it issued the final check-the-box regulations, officially adopting and explicitly elective entity classification regime.[144]

While LLCs had been steadily increasing in popularity even before the IRS allowed an explicit entity election, the check-the-box regulations allowed the form to explode in popularity. Beginning in 2001, LLCs filed the majority of partnership tax returns.[145] By 2019 (as of this writing, the latest year for which the IRS had released its data), 2.7 million LLCs filed partnership tax returns, comprising

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[140] *See* William J. Rowe, *Right Without Reason? The Check-the-Box Corporate or Partnership Election Regulations Correctly Held Valid:* Littriello v. United States, 59 TAX LAW. 913, 922 (2006) ("[W]hile the Kintner regulations were in force, taxpayers manipulated their business forms to satisfy the required Kintner factors and achieve the desired tax result, thereby making the choice of entity an elective one for the taxpayer."); *see also* Littriello v. United States, No. 3:04CV-143-H, 2005 WL 1173277, at *9 (W.D. Ky. May 18, 2005) ("A business entity could pick at will which two corporate characteristics to avoid in order to qualify as a partnership under the Kintner regulations.").

[141] *See* IRS Notice, *supra* note 137 ("Taxpayers and the Service . . . continue to expend considerable resources in determining the proper classification of domestic unincorporated business organizations.").

[142] *Id.*

[143] *See* Hamill, *The Origins*, *supra* note 90, at 1483 ("On March 30, 1995, the IRS announced proposal to eliminate the partnership classification rules by allowing . . . LLCs[] to elect partnership or corporate taxation . . . [and t]he public overwhelmingly favored the proposal.").

[144] *See id.* ("[O]n December 17, 1996, the final regulations, dubbed the 'Check-the-Box' regulation, permanently eliminated all partnership classification considerations for LLCs and all other domestic unincorporated entities.").

[145] *See* Ron DeCarlo, Tuba Ozer-Gurbuz & Nina Shumofsky, *Partnership Returns, Tax Year 2019*, 41 STAT. INCOME BULL. 1, 10 (2021).

71.5 percent of partnership returns.[146] Since the implementation of the check-the-box regulations, then, the use of LLCs has increased twentyfold.

B. HOW THE CHECK-THE-BOX REGULATIONS WORK

The check-the-box regulations entirely discard the idea of a Platonic corporation or partnership. They are unconcerned with whether an entity has sufficient partnership attributes to count as a partnership. Rather, the check-the-box regulations literally allow the founders of business entities to check a box on a form to determine their tax entity status.[147]

In most cases, that is. They do not allow for electivity for every entity. Rather, certain entities (including those incorporated under state or federal law) are taxed as corporations and cannot elect out of that treatment.[148] Likewise, the regulations provide a list of eighty-seven non-U.S. entities that cannot elect out of being treated as corporations for U.S. federal income tax purposes.[149]

If an entity is not subject to mandatory corporate treatment, it can choose its entity status for tax purposes.[150] The check-the-box regulations do not, however, mandate that entities make an election.[151] Rather, for non-corporate entities they provide a default rule and the option to opt out of that default rule.[152]

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[146] *Id.*

[147] *See* I.R.S. FORM 8832, OMB NO. 1545–1516 (Dec. 2013) [hereinafter IRS FORM], https://www.irs.gov/pub/irs-pdf/f8832.pdf (providing boxes to check off as to how to classify the entity).

[148] *See* Treas. Reg. § 301.7701-2(b) (as amended in 2019) ("[A] business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.").

[149] *See id.* § 301.7701-2(b)(8) (listing entities that cannot elect out of corporate tax treatment).

[150] *See id.* § 301.7701-3(a) (as amended in 2020) ("A business entity that is not classified as a corporation [under the Treasury regulations] can elect its classification for federal tax purposes as provided in this section.").

[151] See *id.* (using the permissive language "can" to modify how a corporation elects its tax classification).

[152] *See* Thomas M. Hayes, *Checkmate, the Treasury Finally Surrenders: The Check-the-Box Treasury Regulations and Their Effect on Entity Classification*, 54 WASH. & LEE L. REV. 1147, 1164 (1997) ("In an effort to simplify entity classification even further, the new regulations contain default rules to provide new and pre-existing entities with a tax classification absent an election.").

A non-corporate domestic entity that does not make an election defaults into one of two things. If it has two or more owners, the tax law will treat it like a partnership.[153] If it has one owner, the tax law will treat it like a disregarded entity.[154] A *disregarded entity* is one that is ignored for tax purposes.[155] Rather than obtaining a tax identification number and filing tax or information returns on behalf of the disregarded entity, its owner includes the disregarded entity's income and deductions on the owner's tax return.[156]

Foreign non-corporate entities face three default classifications. Like domestic entities, if a foreign entity not on the de facto corporation list has a single owner, it is treated as a disregarded entity.[157] If it has two or more owners and at least one owner has unlimited liability, it defaults as a partnership.[158] If all of the foreign entity's owners have limited liability, in a nod to the prior rules that counted at corporate characteristics, the entity defaults as a corporation for tax purposes.[159] (For purposes of the check-the-box regulations, "limited liability" means that an owner "has no personal liability for the debts of or claims against the entity by reason of being a member" based on the law in the jurisdiction in which the entity is organized.[160])

This default categorization, while necessary, is not mandatory. Rather, any entity treated as a partnership or disregarded entity by default can instead elect to be taxed as a corporation.[161] And any entity treated as a corporation—by virtue of having at least one member with unlimited liability but not on the list of mandatory

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[153] *See* Treas. Reg. § 301.7701-3(b)(1)(i) (as amended in 2020) ("[A] domestic eligible entity is . . . [a] partnership if it has two or more members . . . .").

[154] *See id.* § 301.7701-3(b)(1)(ii) ("[A] domestic eligible entity is . . . [d]isregarded as an entity separate from its owner if it has a single owner.").

[155] *See* Stephanie R. Hoffer, *Give Them My Regards: A Proposal for Applying the COD Rules to Disregarded Entities*, 107 TAX NOTES 327, 331 (2005) (explaining that a disregarded entity is not a taxpayer).

[156] *See id.* at 335 (explaining that items of income and deduction generally continue to pass through to the owners).

[157] *See* Treas. Reg. § 301.7701-3(b)(2)(i)(C) ("Except as provided in paragraph (b)(3) [which lists existing eligible entities] . . . a domestic eligible entity is . . . [d]isregarded as an entity separate from its owner if it has a single owner that does not have limited liability.").

[158] *See id.* § 301.7701-3(b)(2)(i)(A) (explaining that a domestic eligible entity is a partnership if it has two or more members and at least one doesn't have limited liability).

[159] *Id.* § 301.7701-3(b)(2)(i)(B).

[160] *Id.* § 301.7701-3(b)(2)(ii).

[161] *See id.* § 301.7701-3(a) (describing eligible entities).

corporations—can elect instead to be taxed as a partnership.[162] Single-owner entities cannot, however, elect to be treated as partnerships and multi-owner entities cannot elect to be treated as disregarded entities.[163]

Not only did Treasury shift to an explicitly elective entity classification regime when it finalized the check-the-box regulations, but it also created a simple method for doing so. An electing entity must file a Form 8832 with the IRS.[164] Currently, Form 8832 is three pages long.[165] It asks for identifying information from the entity, including name, address, and employer identification number, then provides a series of questions about the entity.[166] An applicant ultimately checks one of six boxes, depending on what type of entity it elects, and all of the owners (or a designated representative) sign the election form.[167]

A taxpayer can file the Form 8832 with the IRS up to seventy-five days after they want it to go into effect or up to twelve months prior to its effective date.[168] Once an entity makes an election under the check-the-box regulations, it generally cannot make a new election without IRS permission for five years.[169]

The check-the-box regulations were not an unalloyed good, of course. Arguably their enactment represented "regulators at Treasury or IRS revising interpretations of the tax code to favor the wealthiest."[170] For instance, the check-the-box regulations opened the door to international tax arbitrage.[171] A U.S. taxpayer can form a pass-through entity in a foreign jurisdiction and elect to treat it

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[162] *Id.*

[163] *Id.*

[164] *Id.* § 301.7701-3(c)(1)(i).

[165] IRS FORM, *supra* note 147.

[166] *Id.*

[167] *Id.* The last place allows an applicant to explain why they filed the election late if they filed late. *Id.*

[168] *See* Treas. Reg. § 301.7701-3(c)(1)(iii) (as amended in 2020) (establishing the timeframe).

[169] *See id.* § 301.7701-3(c)(1)(iv) (establishing the limitation).

[170] David Gamage & John R. Brooks, *Tax Now or Tax Never: Political Optionality and the Case for Current-Assessment Tax Reform*, 100 N.C. L. REV. 487, 527 (2022).

[171] *See* Adam H. Rosenzweig, *Harnessing the Costs of International Tax Arbitrage*, 26 VA. TAX REV. 555, 617 (2007) (noting that the regulations "fundamentally altered the opportunities for international tax arbitrage").

as a corporation for U.S. tax purposes.[172] In at least some jurisdictions, by doing so, a taxpayer could entirely avoid taxation.[173] The foreign jurisdiction would treat income as taxable not to the entity but to its members located outside of that jurisdiction.[174] At the same time, the U.S. would treat it as a foreign corporation and its income would go untaxed until the entity distributed the income to its U.S. owners.[175]

The check-the-box regulations facilitate certain abusive tax behavior.[176] Nonetheless, they were nonetheless wildly successful at what they were designed to do: reduce the administrative burden on both taxpayers and the IRS[177] and make it less costly to do business through new entity forms.[178] In 2020, more than 180,000 LLCs were formed in Delaware alone, representing nearly three-fourths of business entities formed in Delaware that year.[179] In one state in one year, people formed more than 100 times as many LLCs as were formed in the first thirteen years that they existed in the U.S.[180] And that explosion became possible in significant part because the check-the-box regulations provided certainty to LLC founders of what tax treatment they would receive.

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[172] *See* David L. Cameron & Philip F. Postlewaite, *Incremental International Tax Reform: A Review of Selected Proposals*, 30 NW. J. INT'L L. & BUS. 565, 577 (2010) (discussing classification differences across jurisdictions).

[173] *See id.* (describing the mechanics of avoiding taxation).

[174] *Id.*

[175] *Id.* It is worth noting that this type of structure—called a "reverse hybrid structure"—currently faces pushback in Europe under the EU Anti-Tax Avoidance Directive. *See* Thomas Kollruss, *Reverse Hybrid Mismatches and International Taxation: The U.S. Perspective*, 131 J. TAX'N 7, 7 (2019) (commenting on the EU's "attack" on the structure).

[176] *See, e.g.*, Heather M. Field, *Checking in on Check-the-Box*, 42 LOY. L.A. L. REV. 451, 491 (2009) ("[T]he risk of abuse enabled by the application of [check-the-box] regulations to foreign entities seems to outweigh the benefits.").

[177] *See, e.g.*, *id.* at 473 ("The increased simplicity and certainty created by the CTB regulations also eases administrability by making it easier for the Service to identify which entities will be treated as corporations and which will be treated as partnerships (or disregarded entities).").

[178] *See, e.g.*, Hamill, *The Story of LLCs*, *supra* note 84, at 308 (presenting the "more direct and . . . more transaction cost free route" that the regulations offer to businesses).

[179] *See* DEL. DIV. OF CORPS., 2020 ANNUAL REPORT STATISTICS, https://corpfiles.delaware.gov/Annual-Reports/Division-of-Corporations-2020-Annual-Report.pdf (showing the LLCs represented over 180,000 of the almost 250,000 business entities formed in 2020).

[180] *See supra* note 129 and accompanying text.

IV. CHECK-THE-BOX AND DAOS

The same check-the-box that made the widespread adoption of LLCs viable has also opened the door for DAO founders to have certainty about their tax status. While some ambiguity exists around the margins, for the most part DAOs will face the same defaults and elective options available to any other unincorporated entity: as long as they have two or more owners, they will be partnerships for tax purposes unless they elect corporate status.[181]

That status may not be immediately obvious. After all, the state law entity status of DAOs is not absolutely certain.[182] While they are probably partnerships for state law purposes, it is possible that they are not.[183] But while that marginal uncertainty may matter for some purposes, it does not exist for tax purposes.[184]

The tax law does not treat a DAO as a partnership from the moment its founder conceives of it, of course. Before the tax law treats an unincorporated entity like a DAO like a partnership it must begin its business activities.[185] Once it is engaged in business, though, its tax entity status does not depend on its owners'

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[181] While DAOs almost certainly default as partnerships, there is at least some uncertainty about it. One commenter flatly asserts that DAOs are, "by default, treated as foreign corporations if all their members have limited liability, and otherwise are treated as partnerships." Jason Schwartz, *The Taxation of Decentralized Finance,* 174 TAX NOTES 767, 777 (2022). While I agree that there is some question about the tax residence of DAOs, see *infra* section IV.A., I believe that characterization unduly complicates the analysis of DAO entity status. To the extent DAOs limit the liability of their tokenholders, that limit is not based in law. Rather, it would be based either in contract or the impracticality of discovering the identity of tokenholders. *See* Rodrigues, *supra* note 56, at 713 (concluding that "DAO tokenholders enjoy two main bulwarks against personal liability": pseudonymity and court recognition of the smart contract's validity in the corporeal world). Critically to this Article's thesis, though, even if I am wrong and the default entity classification of DAOs is either ambiguous or is, in many cases, a foreign corporation, that will not impede the development and adoption of DAOs. Whatever the default classification, any DAO can, simply and easily, elect the tax entity status it wants as a result of the check-the-box regulations.

[182] *See* Matthew O'Toole, *Delaware May Be the Right Jurisdiction for "Smart" Orgs*, LAW360 (Feb. 16, 2018, 12:41 PM), https://www.law360.com/articles/1013208/delaware-may-be-the-right-jurisdiction-for-smart-orgs (discussing how the correct manner for treatment of DAOs in all jurisdictions is unknown).

[183] *See supra* notes 65–76 and accompanying text.

[184] *See* O'Toole, *supra* note 182 (discussing the uncertainty that exists various jurisdictions for tax treatment of DAOs).

[185] 6611, Ltd. v. Comm'r, 105 T.C.M. (CCH) 1309 ("A partnership does not come into existence for tax purposes until it begins its business activities.").

preferences. An entity can be treated as a partnership even where the owners expressly agree that the entity will not be treated as a "partnership, agency, employer-employee, or joint venture."[186]

And even prior to the promulgation of the check-the-box regulations, a non-partnership could be treated as a partnership for tax purposes. In determining whether a business endeavor was a partnership, the Tax Court in *Luna v. Commissioner* enunciated eight factors it would consider when deciding on the tax status of unincorporated entities:

> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.[187]

While none of the eight factors was conclusive,[188] courts and the IRS would use them as a balancing test.[189] If a business checked enough of these boxes, it was a partnership for tax purposes.[190]

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[186] I.R.S. CCA 201323015 (June 7, 2013).

[187] Luna v. Comm'r, 42 T.C. 1067, 1077–78 (1964).

[188] *See id.* at 1077 (discussing how the eight factors this court considered in deciding on the tax status of unincorporated entities were inconclusive).

[189] *See, e.g.*, I.R.S. CCA 201323015 (June 7, 2013) ("[W]e do not treat any one factor as determinative, but we consider and weigh each factor in the overall determination of whether a joint venture exists.").

[190] *See id.* (explaining by example how consideration of the *Luna* factors indicated that an enterprise was a joint venture).

As applied, the *Luna* test proved fairly strict, and the Tax Court frequently found that business arrangements that the IRS asserted were partnerships did not meet that standard.[191] The check-the-box regulations, by contrast, take a more liberal view of partnership status. They expressly categorize joint ventures and "other contractual arrangement[s]" provided the people involved "carry on a trade, business, financial operation, or venture and divide the profits therefrom" as tax entities.[192] In fact, the only multi-participant endeavors that do not constitute tax entities involve joint undertakings to share expenses or to co-own and maintain property to rent or lease to third parties.[193]

With their entity definition this broad, then, the check-the-box regulations were abundantly successful in future-proofing entity taxation.[194] Proponents and adopters of new entity forms no longer

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[191] *See, e.g.*, Gabriel v. Comm'r, 66 T.C.M. (CCH) 1283, 1287 (1993) ("We find that petitioner and Messrs. Hall and Maggs were merely passive copurchasers of an interest in the GGS–GIM program and that their interest in the G2MH account did not constitute a partnership . . . ."); Koss v. Comm'r, 57 T.C.M. (CCH) 882, 890 (1989), aff'd, 908 F.2d 962 (3d Cir. 1990) ("We have given weight to several factors enumerated in [*Luna*] in reaching our conclusion that no partnership or joint venture existed in regard to the Dynetics stock."); Herrick v. Comm'r, 47 T.C.M. (CCH) 1550 (1984) ("Applying the [*Luna*] factors to the record herein, we similarly conclude that petitioner and Farmers were not joint venturers."); Kelly v. Comm'r, 29 T.C.M. (CCH) 1090, 1102 (1970) ("After a careful examination of the entire record in light of these [*Luna*] principles, we conclude that McCartan was never, in substance, a partner in the firm of J. R. McCartan & Co., or its successor McCartan Kelly & Co.").

[192] Treas. Reg. § 301.7701–1(a)(2) (as amended in 2011).

[193] *See id.* ("Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes . . . 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."). Even if ambiguity existed as to whether DAOs were tax entities, that ambiguity would not likely last long. On June 6, 2022, Senators Lummis and Gillibrand introduced a bill that would broadly rewrite the regulation of the crypto industry. *See* Tory Newmyer, *Crypto Industry Scores Big Win Under Long-Anticipated Senate Bill*, WASH. POST (Jun. 7, 2022), https://www.washingtonpost.com/business/2022/06/07/crypto-lummis-gillibrand-regulation/ (noting how the crypto currency industry will be undergoing "comprehensive" regulation due to the newly anticipated Senate proposal sponsored by Senators Lummis and Gillibrand). One section of the bill clarifies that, for tax purposes, DAOs will, by default, be business entities that are not disregarded for tax purposes. *See* Lummis-Gillibrand Responsible Financial Innovation Act, S.4356, 117th Cong. § 204 (2022) ("The default classification of a decentralized autonomous organization shall be as a business entity which is not a disregarded entity."). The proposed bill does not lay out the entity status of DAOs, but it explicitly places them within the reach of the check-the-box regulations.

[194] *See* INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, DCN ORE/C/19_02-01, OVERVIEW OF ENTITY CLASSIFICATION REGULATIONS (A/K/A/ CHECK-THE-BOX) (2017)

need to determine whether the form looks like a partnership or corporation. They no longer need to figure out how many characteristics of each they need. Legislatures no longer need to constrain newly created entities in ways that allow for the best possible tax treatment.[195] Likewise, inventors of new unincorporated entities do not need to worry about the state law treatment of their new entity.[196] Rather, all new noncorporate business forms—including DAOs—will default as partnerships for tax purposes provided they have more than one owner.[197]

While the check-the-box regulations have future-proofed the tax law against new and unanticipated entity forms, however, they have not necessarily made those forms easy. Rather, new forms have to meet the tax requirements applicable to either partnerships or corporations.[198] And while a new DAO can choose one or the other, either choice brings with it complexity and, in some cases, disallows—or, at least, makes substantially more difficult—things (such as investor privacy) that are central to the ethos of DAOs.

V. THE BURDENS OF A TAX STATUS

The existence of the check-the-box regulations protects DAOs from the massive uncertainty that impeded the quick uptake of LLCs. Under the check-the-box rules, a DAO defaults as a partnership.[199] But even if DAO founders worried that they would not default as a partnership, they can ameliorate any potential ambiguity by filing a simple form with the IRS.[200] Any DAO can get

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https://www.irs.gov/pub/int_practice_units/ore_c_19_02_01.pdf (noting the positive change from uncertainty to certainty in taxation for entities).

[195] *See* Sandra Feldman, *Understanding LLC Law: Its Past and Its Present*, WOLTERS KLUWER (Sept. 30, 2021) https://www.wolterskluwer.com/en/expert-insights/understanding-llc-law-its-past-and-its-present (using LLC's origin in the U.S. as an example to explain how the legislature had to pass statutes to regulate the new entity form for tax purposes).

[196] *See supra* notes 73–76 and accompanying text.

[197] *See* REVISED UNIF. P'SHIP ACT § 101(6) (2021) (defining partnership as "an association of two or more persons to carry on as co-owners a business for profit").

[198] *See* Treas. Reg. § 301.7701-3 (as amended in 2020) (containing the rules to classify an entity for tax purposes).

[199] *See supra* notes 153–1159 and accompanying text.

[200] *See* IRS FORM, *supra* note 147 (allowing entities to choose their entity form for tax purposes).

the benefits of pass-through taxation or, if it would be advantageous to that particular DAO, corporate taxation.[201]

Here, though, the putative autonomy of a DAO could cause problems. Unless the founders understand and anticipate the need to make an entity election—and create smart contracts to make such an election—it is not clear who would make the check-the-box election. If nobody is authorized to make the election, DAOs are generally stuck with partnership treatment,[202] irrespective of what would be most advantageous.

Even assuming that a DAO has anticipated the need to make tax elections, moreover, the simplicity of the check-the-box rules comes at a cost: whichever tax status a DAO decides to adopt, it must conform to the tax rules governing that status.[203] DAOs, however, may not anticipate or understand their tax obligations. Technology companies—including blockchain companies—are notoriously averse to believing that preexisting rules apply to them.[204] The crypto community has adopted a "move-fast-and-break-things ethos."[205] But that ethos may run into the brick wall of the IRS.

By contrast to the crypto community's vision of themselves as *sui generis*,[206] the IRS has generally (and rightly) slotted crypto into traditional categories.[207] It announced, for example, that cryptocurrency would be treated like property rather than

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[201] *See id.* (granting that the filing entity can choose to be a partnership or corporation); I.R.S CCA 201323015 (June 7, 2013) (noting restrictions for which entities can choose their form for taxation purposes).

[202] *See* Treas. Reg. § 301.7701-3 (stating election procedures and defaults).

[203] *See id.* (stating tax rules for with entity form election); I.R.C. §§ 701–61 (listing tax rules for partners and partnerships); I.R.C. §§ 11–12 (listing tax rules for corporations and citing to additional sections for clarity of rules).

[204] *See* David Streitfeld, *To Take Down Big Tech, They First Need to Reinvent the Law*, N.Y. TIMES (June 20, 2019) https://www.nytimes.com/2019/06/20/technology/tech-giants-antitrust-law.html (noting how BigTech has avoided antitrust actions for so long that they own a vast majority of their respective industry power).

[205] Michael P. Regan, *Wormhole Rescue Shows Crypto World Can Move Fast and Fix Things*, BLOOMBERG (Feb. 3, 2022, 3:50 AM), https://www.bloomberg.com/news/articles/2022-02-03/wormhole-rescue-shows-crypto-world-can-move-fast-and-fix-things.

[206] A Web3 blog uses the term to describe their crypto-based community. *See* W3C Team, *Calls for Participation in Bitcoin Community Group*, W3 (Sept. 21, 2019), https://www.w3.org/community/bitcoin/ (noting the community's intention to focus on the "sui generis nature" of bitcoin creation).

[207] *See* I.R.S. Notice 2014-21, 2014-16 I.R.B. 938 (placing virtual currency into specific categories for tax purposes).

currency,[208] meaning, among other things, that taxpayers have basis in their cryptocurrency and that spending cryptocurrency is a realization event that can result in taxable gain.[209] With respect to DAOs, while a DAO's aspirational autonomy from individual choices may work in non-tax contexts, it breaks down when it comes to tax. Any partnership must designate a person—partner or not—who has "sole authority to act on behalf of the partnership" in any tax matter.[210] That partnership representative's actions bind the other DAO owners.[211] Moreover, if the partnership declines to select a partnership representative, the IRS can select somebody, and the IRS's selection will have power to bind the partnership for tax purposes, irrespective of the DAO's internal governance.[212] A DAO's autonomy from individual decision-making goes away in the tax context.

That does not mean, of course, that there is no ambiguity or uncertainty when it comes to emerging technology. It does mean, however, that a DAO that defaults or has elected to be treated as a partnership must follow the tax rules that govern partnerships and that a DAO that has elected to be treated as a corporation must follow the tax rules that govern corporations.[213] And it must do so even if the rules burden it in a way it would prefer not to be burdened.

While Treasury clearly did not have DAOs in mind when it promulgated the check-the-box regulations, the solution to the LLC problem it landed on effectively future-proofed entity taxation. Even without considering the (at the time, unimaginable) possibility of blockchain-based decentralized organizations, the check-the-box rules allow the easy default categorization of DAOs, as well as the ability of DAO founders and owners to change that default. This certainty and flexibility have allowed DAOs to flourish, and to do so much faster than LLCs could.

But while the futureproofing of tax entity status is ultimately beneficial for DAOs and their sponsors, it also adds a layer of

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[208] *See id.* ("For federal tax purposes, virtual currency is treated as property.").

[209] *See id.* ("If the fair market value of property received in exchange for virtual currency exceed the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain.").

[210] I.R.C. § 6223(a).

[211] *See id.* § 6223(b) (stating how partners can be bound by the other's action).

[212] *See id.* § 6223(a) (noting when the Secretary may select a partnership representative).

[213] *See, e.g.*, *infra* note 257 and accompanying text (discussing the burdens that tax disclosure rules may place on DAOs in light of the anonymity of DAOs).

formality and regulation to an entity that in many cases seems to prefer to avoid both. Because partnership taxation is complicated and imposes certain obligations on partnerships and their members, DAOs would do well to meet those obligations. The following subsections will review some of the tax questions and ambiguities that will face DAOs as they navigate entity taxation.

A. DISTRESSINGLY COMPLEX AND CONFUSING

While partnership status relieves tax partnerships from the burden of taxpaying, they remain deeply entangled with the tax law. In fact, the Tax Court has described partnership tax rules as "distressingly complex and confusing."[214] And those complex and confusing rules create "substantial compliance burdens" for partners and partnerships,[215] compliance burdens that DAO founders and investors may not anticipate.

With forethought, a DAO may be able to avoid some of those burdens. The Internal Revenue Code (the Code) provides a limited election out of some or all of the partnership tax rules.[216] Essentially, no unincorporated entity that engages in any type of trade or business or that owns property at the entity level can take advantage of this election out of the partnership tax rules.[217] Even if a particular DAO qualifies for this election out, however, its founders must be aware in advance that by default the DAO would be taxed as a partnership, that they do not want partnership tax treatment, and that the election is available. In most cases, then, unless a DAO elects under the check-the-box regulations to be treated as a corporation, it will be treated as a partnership, subject to the complex and confusing partnership tax regime.

While there are myriad causes of complexity in the partnership tax regime, the primary driver is the fact that it is a pass-through regime, admitting only one level of taxation.[218] Central to this single

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[214] Foxman v. Comm'r, 41 T.C. 535, 551 n.9 (1964), aff'd, 352 F.2d 466 (3d Cir. 1965), & *acq.*, IRS Announcement Relating to: Foxman, Grenell, Jacobowitz, 1966-28 I.R.B. 5.

[215] David Hasen, *A Partnership Mark-to-Market Tax Election*, 71 TAX LAW. 93, 136 (2017).

[216] *See* I.R.C. § 761(a) (outlining when a partnership may be excluded from the application of all or part of the regulations on partnerships).

[217] *See* Treas. Reg. § 1.761-2(a) (as amended in 1995).

[218] *See* Andrea Monroe, *Hidden in Plain Sight: IRS Publications and a New Path to Tax Reform*, 21 FLA. TAX REV. 81, 127 (2017) (noting that, unlike a corporation, a partnership's income is subject to only one level of taxation).

level of taxation is an allocative obligations—partnerships must allocate income to their partners so that the partners can pay taxes on that income.[219] Because of the broad range of entities covered by partnership taxation—ranging from small and informal businesses to incredibly sophisticated financial businesses—the partnership rules must also "be nimble, with rules that prioritize partnership flexibility."[220]

While it is beyond the scope of this Article to relate all of the complexity that partnership tax entails, one example—salient to DAOs—will help to illustrate. In general, to get voting rights in a DAO, a would-be owner buys a cryptocurrency token and contributes that token to the DAO.[221] The more tokens an owner has, the more votes they get in the DAO's operations.[222]

Tokens are not money, though—for tax purposes, they are treated as property.[223] Generally speaking, exchanging a token for other property would be a realization event, subject to taxation.[224] The tax law has an exception, though, when property is exchanged for an ownership interest in a partnership. Where an individual contributes a crypto token in exchange for an ownership interest in a DAO treated as a partnership, they will not recognize any gain or loss on the contribution.[225] Instead, the new DAO owner will take a basis in their DAO interest equal to their adjusted basis in the token

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[219] *See id.* (noting how the pass-through structure of a partnership must "perform a unique allocative function, dividing the partnership's income among its partners each year").

[220] *Id.*

[221] *See* Luc Olinga, *A Beginner's Guide to DAO, Killer of Hedge Funds and Corporate Structure*, THESTREET, Feb. 12, 2022, https://www.thestreet.com/investing/cryptocurrency/a-beginners-guide-to-dao-killer-of-hedge-funds-and-corporate-structure (describing the structure of DAOs).

[222] *See id.* (explaining how buying more tokens gives an individual more voting rights and thereby more power, which creates a risk for other participants should one person take advantage of this structure and "divert the project from its original objective").

[223] *See* I.R.S. Notice 2014-21, 2014-16 I.R.B. 938 ("For federal tax purposes, virtual currency is treated as property.").

[224] *See id.* (explaining to citizens that "[g]eneral tax principles applicable to property transactions apply").

[225] *See* I.R.C. § 21(a) ("No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.").

they contributed.[226] At the same time, the DAO will take a carryover basis in the contributed token.[227]

Over time, the value of contributed property and the value of an ownership interest in the DAO can diverge. Cryptocurrencies are notoriously volatile assets.[228] In the most extreme example, on occasion Bitcoin has lost twenty percent of its value "within a matter of minutes."[229] It often swings "more than two standard deviations from its average" valuation.[230] The volatility extends beyond just the short-term, though. In the second quarter of 2022, Bitcoin lost nearly sixty percent of its value.[231] In the same period, Ether was down nearly seventy percent.[232] In order to pursue their goals, however, DAOs must either spend the cryptocurrencies investors have contributed or convert those cryptocurrencies into currency.[233] Either way, to the extent that the cryptocurrency has appreciated in value, the DAO recognizes gain (and to the extent it has lost value, the DAO can recognize loss).[234]

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[226] *See id.* § 722 ("The basis of an interest in a partnership acquired by a contribution of property . . . to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner . . . increased by the amount . . . of gain . . . to the contributing partner.").

[227] *See id.* § 723 ("The basis of property contributed to a partnership . . . shall be the adjusted basis of such property to the contributing partner . . . increased by the amount . . . of gain . . . to the contributing partner.").

[228] *See* Marco Dell'Erba, *Stablecoins in Cryptoeconomics: From Initial Coin Offerings to Central Bank Digital Currencies*, 22 N.Y.U. J. LEGIS. & PUB. POL'Y 1, 4–5 (2020) (describing how the volatility of cryptocurrencies make them an inferior type of currency).

[229] Vildana Hajric & Katherine Greifeld, *Bitcoin Went Mainstream in 2021. It's Just as Volatile as Ever*, BLOOMBERG (Dec. 21, 2021), https://www.bloomberg.com/graphics/2021-bitcoin-volitility/.

[230] *Id.*

[231] *See* Arjun Kharpal, *Bitcoin Posts Its Worst Quarter In More Than a Decade*, CNBC (Jun. 30, 2022, 4:25 PM), https://www.cnbc.com/2022/06/30/bitcoin-btc-on-track-for-its-worst-quarter-in-more-than-a-decade.html (stating that Bitcoin "has lost around fifty-eight percent of its value in the second quarter of 2022").

[232] *See id.* ("[E]ther is down 69.3% in the second quarter.").

[233] *See, e.g.*, Gail Weinstein, Steven Lofchie & Jason Schwartz, *A Primer on DAOs*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 17, 2022) https://corpgov.law.harvard.edu/2022/09/17/a-primer-on-daos/ (discussing how "ConstitutionDAO partnered with a cryptocurrency exchange to converts its ether to dollars" in order to pursue its goals when auctions did not accept digital currencies).

[234] For tax purposes, cryptocurrencies are treated as property. Exchanging property for goods and services is a realization event, resulting in taxable capital gain or loss. *See* IRS Notice 2014-21, 2014-16 I.R.B. 938, 938–39 (2014) (directing that the IRS will treat cryptocurrencies as property for federal tax purposes).

By the very nature of their funding, then, DAOs are tremendously tax-inefficient unless they exchange contributed cryptocurrencies for dollars immediately upon receiving the cryptocurrency.[235] Most DAOs would ultimately be indifferent to the tax realization, though, because, as tax partnerships, DAOs are not taxpayers. Rather, they pass any gain through to the owners, who have to pay taxes on their share of the gains whether or not the DAO makes any distribution.[236]

But the fact that the tax law treats cryptocurrencies as property, subject to gain or loss on their disposition is not the only complexity implicated by funding a DAO with cryptocurrency. Even though partnerships do not pay taxes, the volatility of a DAO's cryptocurrency assets will also impose a tax compliance burden on the DAO. Partnership taxation is designed to allow partners to "move property in and out of partnerships with the least possible tax disincentive."[237] To prevent this type of disincentive, a partner who receives a distribution from a partnership does not have any gross income as long as the distribution consists of property or, if cash, the distributed cash does not exceed the partner's basis in the partnership.[238] Similarly, the partnership does not recognize any gain or loss when it distributes property to a partner, even if it has a built-in gain or loss.[239]

This type of nonrecognition on distribution makes it possible for a partnership to significantly defer its realization of gain.[240] For instance, assume an investor contributes a cryptocurrency token to a DAO when that token is worth $100. The investor now has a basis of $100 in their interest in the DAO, while the DAO has a basis of $100 in the token. Five years later, the owner's basis in their

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[235] In theory, they could exchange the contributed cryptocurrencies for stablecoins. Stablecoins use algorithms to maintain a one dollar valuation, meaning that, if they are successful, they will never have built-in gain or loss. *See* Dell'Erba, *supra* note 228, at 7 (explaining how stablecoins function).

[236] *See supra* notes 96–100 and accompanying text.

[237] Leigh Osofsky, *Solving Section 734(b)*, 60 TAX LAW. 473, 473 (2007).

[238] *See* I.R.C. § 731(a)(1) (stating that, in the case of a distribution to a partner, "gain shall not be recognized to such partner" unless the distribution "exceeds the adjusted basis of such partner's interest").

[239] *See id.* § 731(b) ("No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.").

[240] *See* Osofsky, *supra* note 237, at 473 (illustrating how nonrecognition allows partners to defer gain).

interest in the DAO has increased to $300.[241] The DAO distributes appreciated property to the owner.[242] The DAO has a basis in the distributed property of $100 but the property has a fair market value of $300. Because of the Code's nonrecognition rule, the DAO recognizes no gain on the distribution.[243] The investor does not include the distribution in gross income.[244]

And what is the investor's basis in the $300 property? As long as the distribution is not in liquidation of the investor's interest, the investor takes a carryover basis in the property.[245] That is, the investor takes a $100 basis in the distributed property. If they sold the property immediately, they would recognize the full $200 of gain and include it in their gross income. The gain, however, was realized while the asset was owned by the DAO. Had the DAO instead sold the asset and distributed money to the owner, the owner would have only had to include their pro rata share of the gain; the gain would have been shared among all of the DAO owners.

If the distribution were, instead, in liquidation of the owner's interest in the DAO, their basis in their DAO interest would attach to the property.[246] They would get a $300 basis and, if they sold the property immediately, would recognize no gain or loss. Furthermore, the DAO would defer its recognition of the gain, possibly until the DAO liquidated entirely.[247]

The check-the-box election gives DAOs a way out of this complexity: they can choose to be treated as a corporation rather

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[241] A partner's basis in their partnership interest increases when, among other things, they include partnership income in their gross income but the partnership does not make a corresponding distribution. *See* I.R.C. § 705(a)(1) (establishing the rule for adjusting partner's interest).

[242] The distributed property could be a token or it could be property that the DAO acquired with its assets.

[243] *See id.* § 721(a) ("No gain or loss shall be recognized to a partnerhsip or to any of its partners in the case of a contribution of property to the partnerships in exchange for an interest in the partnership.").

[244] *See id.* § 731(a)(1) (creating an exception to the gin recognized to such a partner to "the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership *immediately before the distribution*" (emphasis added)).

[245] *See id.* § 732(a)(1) (adjusting the basis of property other than in liquidation of the partner's interest).

[246] *See id.* § 732(b) (outlining the basis of distributed property other than money when the distributions are in liquidation).

[247] *See* Osofsky, *supra* note 237, at 473 (illustrating the recognition of gain by liquidation of property would be deferred).

than a partnership. But that choice carries with it tax cost. An association taxed as a corporation pays taxes at the corporate level,[248] then shareholders pay taxes when the corporation distributes its earnings to them.[249] Neither choice fits with the dominant DAO ethos of building now and hoping the rules either do not find them or adapt to them.[250]

B. ANONYMITY IN THE FACE OF THE TAX LAW

Beyond complex and confusing, in many ways, the partnership tax regime does not match many crypto investors' expectations of privacy. Traditionally, DAOs are made up of "a group of anonymized individuals who decide to follow a certain protocol in decentralized computing systems."[251] This anonymity of ownership is not an accident; it is a feature of DAOs,[252] a feature that the crypto world seems comfortable with. Financial journalist Felix Salmon explained that people are "pouring billions of dollars into" the crypto world while ignoring "the crazy amounts of insider dealing and opacity and scariness and everything that people seem to be perfectly happy with."[253]

While DAOs and their owners may prize anonymity, that anonymity does not work with the partnership tax regime. U.S. partnerships—including DAOs treated as partnerships for tax purposes—must file an information return with the IRS every year.[254] They must also send a copy of that information return to its members.[255]

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[248] *See* I.R.C. § 11(a) (imposing a tax each year on taxable income of every corporation).

[249] *See id.* § 61(a)(7) (noting that taxed gross income includes dividends).

[250] *See supra* note 14 and accompanying text (noting how many other successful companies such as Facebook operate under this ethos).

[251] Wulf A. Kaal, *Blockchain-Based Corporate Governance*, 4 STAN. J. BLOCKCHAIN L. & POL'Y 3, 6–7 (2020).

[252] *See* Matt Hussey, Adriana Hamacher & Stephen Graves, *What Is a Decentralized Autonomous Organization (DAO)?*, DECRYPT (Dec. 15, 2021), https://decrypt.co/resources/decentralized-autonomous-organization-dao (highlighting how a DAO "is a business structure where control is spread out rather than hierarchical").

[253] Felix Salmon, Emily Peck & Elizabeth Spiers, *37.8% Scammier*, SLATE MONEY (May 7, 2022, 7:00 AM), https://slate.com/podcasts/slate-money/2022/05/fear-of-a-disney-replication-in-mississippi.

[254] *See* I.R.C. § 6031(a) (outlining information return requirements for partnerships generally).

[255] *See id.* § 6031(b) (requiring furnishment of copies to partners of information returns).

As a technical matter, a DAO would not have any difficulty sending that information to its anonymous members. Blockchain technology facilitates the transfer of data.[256] But as a legal matter, the anonymity is entirely incompatible with the information return requirement. Among other things, a partnership information return must include the names and addresses of all persons entitled to share in the entity's taxable income as well as each person's distributive share.[257]

And a DAO that failed to comply with the partnership return requirements would face massive—and potentially unlimited—financial liability. Any taxpayer, including a DAO, that fails to provide a "payee statement" (which includes an information return to a partner[258]) faces a penalty of $250 for each return it does not provide.[259] The fine has an annual ceiling of $3 million.[260] If, however, the failure results from a DAO's intentional disregard of the rules, the per-instance fine goes up to $500 and there is no ceiling on the total amount it might owe.[261] Importantly, the payee fine does not only apply where a DAO (or other partnership) does not provide *any* payee statement: it also applies where the payee statement does not include all of the required information.[262] A DAO that does not require its members to disclose identifying information, then, will not be able to provide a full and accurate payee statement and will be subject to this fine.

Partnerships also have to deal with withholding rules. Any person who makes payments of U.S.-source income to non-U.S. persons has to withhold thirty percent (or less if there is an applicable treaty) of the payment and pay that over to the IRS.[263]

[256] *See* Dimitropoulos, *supra* note 62, at 1131 (discussing how blockchain technology assists with transferring any type of data, "not restricted to the transfer of digitized value").

[257] I.R.C. § 6031(a).

[258] *See* Treas. Reg. § 301.6722-1(d)(2)(i) (as amended in 2014) (defining "payee statement" to mean "any statement required to be furnished under . . . Section 6031(b)," which sets out the requirement to provide information statements).

[259] *See* I.R.C. § 6722(a)(1) (setting a penalty of $250 for each statement production failure).

[260] *See id.* (setting a cap for "all such filures during any calendar year [to] not exceed $3,000,000").

[261] *See id.* § 6722(e) (noting that in such an instance the penalty imposed shall be $500 and "the $3,000,000 limitation under subsection (a) shall not apply").

[262] *See id.* § 6722(a)(2)(B) ("[F]ailure . . . include[s] all of the information required to be shown on a payee statement or the inclusion of incorrect information.").

[263] *See id.* § 1441(a) ("[Every] person, in whatever capacity acting, . . . having the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b)

To the extent that a DAO taxed as a partnership is a domestic entity, nobody has to withhold on payments made to the DAO.[264] The tax law requires a domestic DAO with foreign investors, however, to withhold on payments it makes to those foreign investors.[265] Transactions—even between a DAO and its investors—cannot be fully anonymous.

While a partnership generally faces the same rules whether it is domestic or foreign, a DAO's residence sometimes matters. A foreign partnership does not have to file an information return with the IRS, provided it has no income effectively connected with a U.S. trade or business and it has no U.S.-source income.[266] Essentially, then, to the extent that a DAO has any U.S.-source income, it will be required to file a U.S. return.[267] Even some non-U.S.-source income will be treated as effectively connected with a U.S. trade or business if the income is attributable to a fixed place of business located in the U.S.[268] To the extent there exists any doubt about whether a DAO is engaged in a U.S. trade or business, a DAO must do a facts and circumstances analysis of its actions.[269]

If a DAO has any income that is effectively connected with a U.S. trade or business or that is otherwise derived from U.S. sources, though, it must file an information return unless it meets one of three exceptions. The first is if it has no effectively connected income, $20,000 or less of U.S.-source income, and less than one percent of its tax allocations go to U.S. partners.[270] The second is if the partnership has U.S.-source income but no effectively connected income, it is not a withholding foreign partnership, it has no U.S.

. . . of any nonresident alien individual or any foreign partnership shall . . . deduct and withhold from such items a tax equal to 30 percent thereof.").

[264] *See* Treas. Reg. § 1.1441–5(b)(1) (as amended in 2017) (requiring no withholding "on a payment of an amount subject to withholding . . . that a withholding agent may treat as made to a U.S. payee").

[265] *See id.* § 1.1441–5(b)(2)(B) (setting out withholding on items of income that are connected to "income in the hands of the partners who are foreign persons").

[266] Treas. Reg. § 1.6031(a)–1(b)(1)(i) (as amended in 2020).

[267] *See* I.R.C. § 864(c)(3) (noting that all U.S.-source income except certain types of passive income is effectively connected with a U.S. trade or business).

[268] *See id.* § 864(c)(4)(B)(i–iii) (setting out treatment of "[i]ncome, gain, or loss without the United States").

[269] *See* Treas. Reg. § 1.864–2(e) (as amended in 1975) ("Whether or not such person is engaged in trade or business within the United States shall be determined on the basis of the facts and circumstances in each case.").

[270] *Id.* § 1.6031(a)–1(b)(2) (as amended in 2020).

partners, and any tax liability owed by its non-U.S. partners has been satisfied through withholding.[271] Finally, there is a limited exception for foreign partnership with more than $20,000 of U.S.-source income and U.S. partners. As long as it does not have effectively-connected income, it must file an information return, but only has to send a Schedule K-1 to its U.S. partners.[272]

In the vast majority of cases, then, even if a DAO were treated as a foreign partnership, it could not accept U.S. investors if they insisted upon anonymity. Similarly, a foreign DAO treated as a partnership faces financial pressures to get identifying information from its members. And if a DAO met one of the exceptions for filing a return, it might face an additional potential impediment to preserving the anonymity of its members. The Foreign Account Tax Compliance Act (FATCA) requires certain foreign financial institutions to provide to the IRS the name, address, and taxpayer identification number of each U.S. account holder.[273]

FATCA only applies to *foreign financial institutions*, and not every partnership is a foreign financial institution. The definition of "foreign financial institution" is broad, though. If the DAO is not a U.S. entity, it will be treated as a foreign entity for FATCA purposes, even if it is not organized in any particular country.[274]

The definition of "financial institution" includes banks.[275] It also includes other types of entities, including entities that invest, administer, or manage funds.[276] While neither the IRS nor the courts have yet ruled on whether foreign DAOs meet the definition of "foreign financial institution," and are thus subject to the FATCA disclosure rules, the definition would seem to encompass DAOs.[277]

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[271] *Id.* § 1.6031(a)–1(b)(3)(ii). A withholding foreign partnership is a partnership that has entered into a withholding agreement with the IRS. *Id.* § 1.1441–5(c)(2)(i) (as amended in 2017).

[272] *Id.* § 1.6031(a)–1(b)(3)(iii).

[273] *See* I.R.C. § 1471(c)(1)(A) (setting out the information required to be reported on U.S. accounts including the "name, address, and TIN of each account holder").

[274] *See* Treas. Reg. § 1.1471–5(d) (as amended in 2019) (defining foreign financial institutions and including entities in some instances that are not residents or organized under the laws of a country).

[275] *Id.* § 1.1471-5(e)(1)(i).

[276] *Id.* § 1.1471-5(e)(1)(iii), (e)(4).

[277] *See* Shakow, *supra* note 77, at 938 ("A foreign entity organized like The DAO would seem to fit that description [of a foreign financial institution].").

Even making an election to be treated as a corporation for tax purposes may be insufficient to preserve DAO investors' anonymity. To the extent a DAO that had elected corporate treatment made a distribution out of its earnings and profits, that distribution would be treated as a dividend.[278] In many cases, a payment by a DAO treated as a corporation in redemption of a member's interest would also be treated as a dividend.[279] And when a corporation—including a DAO that has elected to be treated as a corporation for tax purposes—pays a dividend, it must also provide an information return.[280] Similar to the partnership information return, the corporate information return must include, among other things, the "aggregate amount of the dividends" and "the name, address, and taxpayer identification number of [the recipient]."[281]

A DAO investor who was set on preserving some level of anonymity could do so by investing through a corporation or an LLC that has checked the box to be taxed as a corporation. But creating an LLC or a corporation adds an extra level of complexity and ultimately only pushes the question of identity back one level. To the extent the indirect DAO owner wants to receive the amount allocated or distributed by the DAO, the intermediary entity would need to provide information returns.

C. A DOMESTIC OR FOREIGN PARTNERSHIP?

While the check-the-box regulations solve the major questions regarding how a new and unanticipated entity—including a DAO—will be treated for tax purposes, they do not anticipate *every* potential question. Perhaps the largest ambiguity with respect to DAOs—unincorporated entities whose tokenholders may live anywhere in the world—is the question of entity residence.

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[278] *See* I.R.C. § 316(a) (defining a dividend as "any distribution of property made by a corporation to its shareholders" either "out of its earnings and profits accumulated after February 28, 1913," or "out of its earnings and profits of the taxable year").

[279] *See id.* § 301(c) (defining the tax liability of a dividend).

[280] *See* Treas. Reg. § 1.6042-2(a)(1)(i) (as amended in 2017) (requiring "[e]very person who makes a payment of dividends . . . to any other person during a calendar year" to submit "[a]n information return on Form 1099").

[281] *Id.* A DAO investor could preserve some level of anonymity by investing through a corporation or an LLC that had elected partnership treatment. But that would only push the question of anonymity back by one step—when the intermediate entity makes a distribution to its owner, it has to produce the information returns.

For the most part, determining the residence of a partnership does not present any kind of obstacle. A domestic entity is one organized "under the law of the United States or of any [s]tate."[282] A foreign entity is any entity not organized under the laws of the U.S.[283] An entity organized under both U.S. and non-U.S. law is classified as domestic.[284]

While DAOs are tax partnerships, then, for purposes of determining whether a DAO is domestic or foreign, its actual entity status matters. In many cases, it continues to be an easy question. Under the Uniform Partnership Act, a partnership's internal affairs are governed by the "law of the jurisdiction in which the partnership has its principal office."[285] The decentralization of DAOs means, however, that any given DAO may not have a principal office.[286] In that case, it may not have an obvious residence.

Ultimately, though, because a partnership is not a taxpaying entity, for tax purposes its residence is mostly unimportant. In general, unless it affirmatively elects to be treated as a corporation for tax purposes, a DAO will not pay taxes on its income.[287] Rather, its U.S. owners will owe taxes on their share of DAO income,[288] while its non-U.S. owners will potentially owe U.S. taxes on a portion of their U.S.-source income.[289] Those owner tax obligations do not differ depending on whether the DAO is a domestic or foreign entity. For income tax purposes, the residence of a partnership

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[282] I.R.C. § 7701(a)(4).

[283] *See id.* § 7701(a)(5) ("The term 'foreign' when applied to a corporation or partnership means a corporation or partnership which is not domestic.").

[284] *See* Treas. Reg. § 301.7701-5(a) (as amended in 2006) ("Accordingly, a business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity.").

[285] UNIF. P'SHIP ACT § 104(2) (2013).

[286] On the other hand, there may be state law reasons why a DAO would designate a principal office. Wyoming law expressly extended its LLC statute to encompass DAOs. WYO. STAT. ANN. § 17-31-103 (West 2022). In Wyoming's application for LLC status, it requires the applicant DAO to designate a principal office address. WYO. SEC'Y OF STATE, DECENTRALIZED AUTONOMOUS ORGANIZATION LIMITED LIABILITY COMPANY INSTRUCTIONS, https://sos.wyo.gov/Forms/Business/LLC/DAOLLC-ArticlesOrganization.pdf (last updated May 2021).

[287] *See* I.R.C. § 701 ("A partnership as such shall not be subject to the income tax imposed by this chapter.").

[288] *See id.* (setting out that partners are liable for taxes "only in their separate or individual capacities").

[289] *See* Treas. Reg. § 1.1441-5(b)(2)(i)(A) (as amended in 2017) (explaining that withholdings on a foreign partner's distributive shares may be necessary).

matters primarily in determining whether the DAO is a *U.S. person* for certain tax questions as well as the scope of the DAO's withholding obligations.[290]

While DAO residence may not map clearly onto the brick-and-mortar world into which the federal income tax was born, the tax law does lay out some criteria for determining a partnership's residence in the absence of clear evidence. In determining residence for withholding purposes, a withholding agent can look to the partnership's employer identification number, whether communications are mailed to a domestic or foreign address, whether payment is made with regard to an offshore obligation, and whether the withholding agent has a foreign phone number for the partnership.[291]

To the extent a U.S. payor determines that a DAO is a foreign partnership for tax purposes, the U.S. payor potentially has withholding obligations. In most cases, the U.S. payor will treat payments to a foreign DAO as being made directly to its owners.[292] To the extent that any DAO owners do not provide the necessary identifying information (including their name and social security number),[293] a U.S. payor must backup withhold on those owners' distributive shares at a twenty-four percent rate.[294]

The question of withholding changes slightly if the DAO qualifies as a domestic partnership. In that case, as long as it provides an employer identification number to payors, they will not have to backup withhold on their payments.[295] But a domestic DAO may have to withhold on distributions it makes to foreign[296] or domestic

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[290] *See* WILLIAM H. NEWTON, III, 1 INTERNATIONAL INCOME TAX AND ESTATE PLANNING § 8:5 (2d ed. 2022) ("The term *United States person* is the operation key to I.R.C. § 679 grantor trust rule.").

[291] Treas. Reg. § 1.1441-1(b)(iii)(A)(1) (as amended in 2020).

[292] *Id.* § 1.1441-5(c)(1)(i) (as amended in 2017).

[293] For a discussion of the problems with anonymity in the tax context, see *supra* section 0.B.

[294] *See* I.R.C. § 3406(a) ("[T]he payor shall deduct and withhold from such payment a tax equal to the product of the fourth lowest rate of tax applicable under section 1(c) and such payment.").

[295] *Id.*

[296] *See* Treas. Reg. § 1.1441-7(a)(1) (as amended in 2020) (defining withholding agent to include any person, U.S. or foreign, "that has the control receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding").

owners,[297] which again requires it generally to possess some information about its owners' identities. Even the simple case of entity residence, then, runs into questions of the identity of DAO owners. While DAOs do not *need* to resolve the question of residence, failure to do so could be costly to their owners. But while the structure and goals of DAOs do not fit squarely within the tax law as it exists, they do not break, or even confuse, the tax law. Its categories are sufficiently clear, and sufficiently enforced, to encompass DAOs.

VI. CONCLUSION

The first DAO was formed in 2016.[298] Six years later, there were more than 4,000.[299] By contrast, thirteen years after the enactment of the first LLC statute in the U.S., there were still fewer than 2,000 LLCs.[300] One reason that DAOs can flourish is because LLCs caused the IRS to future-proof entity taxation. Since the enactment of the check-the-box regulations, new entity forms do not have to figure out whether they are more like partnerships or more like corporations (an odd analysis in any event, since both are juridic persons whose attributes are not intrinsic, but rather determined by law).

Even lacking certainty about their legal entity type, under the check-the-box regulation, the vast majority of DAOs default as tax partnerships. And any DAO that is not certain it qualifies as a partnership merely needs to file an election with the IRS to get that treatment. But while the check-the-box regulations provide tax certainty for DAOs, they also pull DAOs into the existing tax regime. As different as DAO boosters believe that DAOs are, the tax law both can and does classify them, with the attendant complexity and obligations that classification brings with it.

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[297] *See* I.R.C. § 3406(a) (requiring deductions and withholdings in general in the case of any reportable payments for domestic payees).

[298] *See* Lucas Matney, *VC-Backed DAO Startups Are Racing to Define What DAOs Actually Are*, TECHCRUNCH (Feb. 1, 2022, 12:16 PM), https://techcrunch.com/2022/02/01/vc-backed-dao-startups-are-racing-to-define-what-daos-actually-are/ ("The first-ever DAO . . . was founded back in 2016.").

[299] *See id.* (noting that there are currently "more than 4,100 DAOs").

[300] *See supra* note 129 and accompanying text.

At times, those obligations and complexity require DAOs to do things at odds with their preferences. For instance, when the DAO formed in 2016, over 10,000 anonymous individuals invested more than $168 million in it.[301] And at least one academic defines DAOs as "a group of anonymized individuals who decide to follow a certain protocol in decentralized computing systems."[302]

As this Article has demonstrated, that type of anonymity is not possible for tax purposes. A tax partnership must collect certain identifying information about its partners and provide that information to the IRS.[303] Because of their pass-through nature, they face complex administrative burdens.[304] And answering the question of what type of entity DAOs are does not resolve all of the complex tax questions surrounding them.[305]

In spite of the remaining questions and the mismatch between the ethos of DAOs and what the tax law requires, categorizing DAOs within existing categories is both good for DAOs and good for society. If every time somebody conceived of a new business entity, either Congress had to create a new tax regime or it the new entity had to replicate the uncertainty LLCs faced in their first two decades, entity innovation would be substantially more costly and burdensome. DAOs could not have emerged as quickly as they have, and whatever the next move in entities is, it would face substantial, if not insuperable, impediments.

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[301] Laila Metjahic, *Deconstructing the DAO: The Need for Legal Recognition and the Application of Securities Laws to Decentralized Organizations*, 39 CARDOZO L. REV. 1533, 1534 (2018).

[302] Kaal, *supra* note 251, at 6–7.

[303] *See supra* section 0.B.

[304] *See supra* section 0.A.

[305] *See supra* section 0.C.