CROWDFUNDING: A POPULAR WAY TO INVEST, BUT WATCH OUT FOR TAXES

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INTRODUCTION

Crowdfunding is a relatively recent, internet-based form of raising capital for businesses and other endeavors. While millions of dollars are raised each month through crowdfunding, it is likely that both the providers and the recipients of the amounts raised have not given much thought to the tax consequences of crowdfunding. Sometimes, the recipients of crowdfunding cash may receive a Form 1099-K, *Payment Card and Third Party Network Transactions*, and may be confused about what to do with it. The Internal Revenue Service (the "I.R.S.") recently issued Information Letter 2016-0036 (June 24, 2016) to address the tax treatment of crowdfunding. As discussed below, in the letter, the I.R.S. noted that there are many ways that crowdfunding arrangements can be characterized, depending upon the "facts and circumstances" of each case, and each case can have very different tax implications for the parties.

Crowdfunding is popular because it provides greater access to nontraditional funding sources. In the past, if a person wanted to raise capital to start a business or launch a new product, that person would market his or her business plan to a limited pool of wealthy individuals or institutions. These funding sources included banks, angel investors, and venture capital firms. Thus, the number of key investors was limited.

Crowdfunding is a method of raising capital primarily online, via social media and crowdfunding platforms, that leverages the collective network for greater reach and exposure. By opening the pool of potential investors to anyone having the use of the internet, crowdfunding opens up investing to nearly anyone while also streamlining the traditional investment model.

TYPES OF CROWDFUNDING

Crowdfunding websites, such as kickstarter.com and indiegogo.com, have increased in popularity over the last few years. On these platforms, "creators" or "initiators" of a fundraising campaign seek "contributors" or "backers" to finance their projects. Other sites, such as gofundme.com or causes.com, feature fundraising campaigns for personal or charitable endeavors. There are a variety of crowdfunding arrangements, which may be distinguished by the products or services offered and the goals of the fundraising. The three primary types of crowdfunding are donation-based, rewards-based, and equity-based crowdfunding.

Donation-Based Crowdfunding

Donation-based crowdfunding campaigns provide no financial return to the contributors. Common donation-based crowdfunding initiatives include fundraising for disaster relief, charities, nonprofits, and medical bills.

Rewards-Based Crowdfunding

Rewards-based crowdfunding involves individuals contributing to a business in exchange for a "reward." This generally entails receiving a form of the product or service that the company offers. Even though this method offers backers a reward, it is still generally considered a subset of donation-based crowdfunding since there is no financial or equity return. This approach is a popular option used by Kickstarter and Indiegogo, since it lets business owners incentivize their contributors without incurring significant extra expense or selling ownership shares in their businesses.

Equity-Based Crowdfunding

Equity-based crowdfunding allows contributors to become part-owners of a company by investing capital in exchange for equity shares. As equity owners, the contributors receive a financial return on their investment by ultimately receiving a share of the profits in the form of a dividend or distribution.

Alternative Funding: Traditional Lending Through a Non-Traditional Medium

While generally not considered to be crowdfunding, lending is always an option for raising needed capital, with the lender receiving a fixed repayment of the money that was advanced and an additional return in the nature of interest. The scope of available lenders has greatly expanded with the use of the internet.

For example, any person may advance $100,000 to a new business as a loan. Interest on the unpaid principal of the loan at a 10% rate (or $10,000) would be due every year and the unpaid principal on the loan (or $100,000) would be due five years after the loan is made. Since the money is advanced as a loan, repayment of the loan has priority over any amounts due to a shareholder or other equity investor in the company. However, unlike an equity owner in the business, such lender does not share in the financial success of the business.

TAX CONSEQUENCES

Gross Income

Kickstarter and Indiegogo mention potential taxation on their webpages, but neither provides definitive information on reporting crowdfunding income and paying taxes. Indiegogo simply notes that taxing authorities may classify funds raised on its site as taxable income of the campaign owner and any beneficiary.[1] Kickstarter states that it cannot give tax advice, but it indicates that in the United States funds raised through campaigns on Kickstarter will generally be considered income.

Internal Revenue Code ("Code") §61(a) provides the general rule that, except as otherwise provided in the Code, gross income includes all income, from whatever source derived. Gross income includes all accessions to wealth, whether realized in the form of cash, property, or other economic benefit. However, some benefits that a taxpayer receives are excludable from income, either because they do not meet

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1 See, Indiegogo's "Terms of Use," available at indiegogo.com.

> *"Crowdfunding revenues must generally be included in income to the extent they are received for services rendered or are gains from the sale of property."*

the definition of gross income or because the law provides a specific exclusion for certain benefits that Congress chooses not to tax.

In Information Letter 2016-0036, the I.R.S. indicated that money received is generally included in gross income by the recipient unless any of the following facts exists:

- There is an offsetting liability (such as a repayment obligation) that makes the arrangement into a loan.
- There is a capital contribution to the entity in exchange for an equity interest in the entity.[2]
- The money is a gift made out of detached generosity and without any "quid pro quo."[3]

The I.R.S. noted that the facts and circumstances of a particular situation must be considered to determine whether the money received in a given situation is income.

As a result, crowdfunding revenues generally are includible in income if they are not

- loans that must be repaid,
- capital contributed to an entity in exchange for an equity interest in the entity, or
- gifts made out of detached generosity and without any "quid pro quo."

In addition, crowdfunding revenues must generally be included in income to the extent they are received for services rendered or are gains from the sale of property.

Gifts

Code §102(a) excludes gifts from the definition of income, but the Code is silent as to what constitutes a gift. A gift is generally defined for U.S. Federal income taxes as an amount transferred out of "detached and disinterested generosity."[4] Gift treatment would be disallowed where the reward has a value approximately equal to or greater than the contribution in return for the payment.[5] Therefore, amounts received in a rewards-based crowdfunding campaign that promises a reward that has some value is unlikely to be considered a non-taxable gift.

Non-Shareholder Contribution to Capital

In the case of corporations, Code §118 allows certain receipts to be treated as nontaxable contributions to capital by a non-shareholder. If the creator operates the activity as a corporation and the backer receives no reward, certain requirements must be met for the contribution to be treated as a non-shareholder contribution to capital. In *Chicago, Burlington & Quincy R.R. Co.*,[6] the Supreme Court required that

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2 While not stated in the letter, the applicable Code section providing for nonrecognition of income would be either Code §118 in the case of a corporation or Section §721 in the case of a partnership.

3 While not stated in the letter, the applicable Code section providing for nonrecognition of income would be Code §102.

4 *Commr. v. Duberstein*, 363 U.S. 278 (1960).

5 *U.S. v. American Bar Endowment*, 477 U.S. 105 (1986).

6 *Chicago, Burlington & Quincy R.R. Co. v. Chicago*, 412 U.S. 401 (1973).

the contribution meet five factors:

- It must become a permanent part of the transferee's working capital structure.
- It may not be compensation for services rendered (or presumably for products received).
- It must benefit the transferee commensurately with its value.
- It ordinarily will be used to produce additional income.
- It must be bargained for.

While a crowdfunding contribution may meet some of the criteria, the last factor may be difficult to meet. Due to the nature of a crowdfunding campaign, creators simply post a project and hope backers will choose to contribute. Kickstarter will not provide backer information to a creator until after a project is funded and contributions are received by the creator, so negotiation is not possible.

Timing of Income – Constructive Receipt & Claim of Right Doctrines

Treasury Regulation §1.451-2 contains the constructive receipt doctrine. For income that is not actually in the taxpayer's possession, this regulation provides that income is constructively received by the taxpayer in the tax year during which it is credited to its account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time. Alternatively, income is constructively received if the taxpayer could have drawn upon it during the tax year if notice of intention to withdraw had been given. Treas. Reg. §1.451-2 further provides that income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. However, a self-imposed restriction on the availability of income does not legally defer recognition of that income. Thus, for the taxpayer, the income tax result of a crowdfunding effort depends on all the facts and circumstances surrounding that effort.

Amounts received by a taxpayer under a claim of right that gives the taxpayer complete control over the amounts are also included in gross income, even though the taxpayer may have to return the income. There is no statutory provision setting forth the claim of right doctrine, which has been established by case law. In *North American Oil Co. v. Burnet*,[7] the Supreme Court laid down the foundation for this doctrine. For the income to qualify as being received, there must be a receipt of cash or property that ordinarily constitutes income rather than loans or gifts or deposits that are returnable, the taxpayer needs unlimited control on the use or disposition of the funds, and the taxpayer must hold and treat the income as its own.

Both Kickstarter and Indiegogo warn backers that the websites do not guarantee the completion of the project or the delivery of the reward. This means that once creators receive the funds, they have complete control over them, even if they do not complete the project and deliver the reward. Based on the claim of right doctrine, this income may be taxable in the year of receipt regardless of the creator's accounting method.

Creators can have a timing problem, however, if the income is taxable in one year but the related expenses, which usually would be incurred after completion of a

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[7] *North American Oil Co. v. Burnet*, 286 U.S. 417 (1932).

campaign, are not deductible until the following year. This can create cash flow problems for the creator that could affect the creator's ability to complete the project. To address this issue, creators may plan to end their campaigns early in the year, so that some, if not all, of the expenses of their projects will be incurred during the same year.

CONCLUSION

The tax treatment of crowdfunding arrangements can materially affect the economics of such arrangements. Information Letter 2016-0036 highlights the need for parties to crowdfunding arrangements to carefully review the resulting tax treatment and properly document the arrangement to limit the exposure to an I.R.S. examination. While this letter is the first I.R.S. announcement on the subject, the complexity and uncertainty surrounding such arrangements will require additional I.R.S. guidance. In the meantime, parties in these arrangements may want to discuss the above-described issues with their tax advisors before they decide to invest so that the intended economic benefit is not diluted by unplanned tax consequences.

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