

# ISSUE BRIEF **03.05.20**

## Tax Considerations of Crowdfunding

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Over the last decade, crowdsourced online fundraising has become increasingly widespread. The proliferation of online digital platforms allows anyone who has an internet connection and a good initiative to start their own fundraising activity. These web-based platforms—including GoFundMe, Indiegogo, Kickstarter, and Fundrise—connect like-minded individuals to make financial contributions toward various projects. However, despite the popularity of crowdfunding activities, tax-related considerations are often overlooked because of their novelty. This issue brief reviews key federal and state tax topics for three types of crowdfunding: donation-based crowdfunding, reward-based crowdfunding, and equity-based crowdfunding.

### WHAT IS CROWDFUNDING?

Crowdfunding refers to the process of raising money from a large number of people through the internet for projects, ventures, or donations. Three parties are usually involved in crowdfunding: an initiator (project or campaign creator) who establishes a webpage on the platform and seeks funding, contributors (backers) who make financial contributions, and a platform (host) that facilitates the fundraising activities for a fee.

### DONATION-BASED CROWDFUNDING

Donation-based crowdfunding means backers contribute variable amounts of money to support a specific cause or project, such as donating to an individual's medical funds, funeral expenses, or wedding costs or to natural disaster recovery. It involves no business activities, and the backers receive nothing in return.

Donation-based crowdfunding is the most widely known and participated-in type of crowdfunding in the United States. A Pew Research Center survey revealed that approximately 70% of Americans who gave money through crowdfunding donated to help someone in need.<sup>1</sup> GoFundMe is the most well-known platform in this category. Fifty million people gave more than \$5 billion on GoFundMe as of late 2017.<sup>2</sup>

The tax issues related to donation-based crowdfunding can be discussed from the donors and the recipients' perspectives. Under current rules, only donations to qualified charitable organizations are tax deductible for donors. To obtain the qualified charitable organization status, a group would have to apply and obtain approval from the IRS. Therefore, no matter how charitable the intent or outcome, donors who make payments on GoFundMe cannot claim these funds as charitable contributions, and the amounts are not deductible on donors' federal income tax returns. In addition, from a federal gift tax perspective, donors are subject to the annual \$15,000 gift tax exemption limit, meaning that once the



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donation exceeds this amount, there will be gift tax consequences. However, based on recent statistics, backers usually provide small amounts toward donation-based crowdfunding initiatives and do not trigger gift tax concerns.

The absence of a qualified charitable organization designation for crowdfunding services not only has tax implications for the backers, but also for the platforms. A recent IRS private letter ruling described a scenario where a platform provided crowdfunding services to facilitate funding for charitable organizations in exchange for a fee. The IRS stated that although the platform's clients are qualified charitable organizations or organizations that raise funds for charitable programs, the platform itself does not qualify for tax-exempt status. The ruling also indicates that the IRS looks to the platform's actual operating activities to decide if it is a for-profit entity, depending on whether or not its sole purpose is to conduct a trade or business for income.<sup>3</sup>

There are also several tax considerations for fund recipients. In donation-based crowdfunding, fund recipients may not always be initiators. For example, if an individual starts a campaign to raise money for someone else's medical expenses, the funds raised will not go to the initiator; instead, the patient will receive the funds. If the campaign raises over \$20,000 and involves more than 200 backers, the platform may send a copy of Form 1099-K to the recipient and to the IRS. If the recipient does not report the amount from Form 1099-K on his federal income tax return, the IRS will usually request additional information regarding the mismatched income between Form 1099-K and the income reported on the taxpayer's return.<sup>4</sup>

Although practitioners have different opinions as to whether the platform needs to issue Form 1099-K in the first place, they generally agree that the funds are nontaxable gifts and the recipients do not need to report anything on their returns. To avoid confusion, fund recipients should keep good records to demonstrate to the IRS the nature and source of the funds.<sup>5</sup>

Donation-based crowdfunding also has potential social and moral implications. For example, a recent article in *The Atlantic* suggests that some initiators are able to take advantage of popular storylines to get more donations. However, some of the storylines they use are problematic and perpetuate the idea of a savior who swoops in to save the day. Furthermore, stories or individuals who do not fit the narrative often get overlooked, bringing up questions of whether or not crowdfunding exacerbates socioeconomic inequalities.<sup>6</sup>

There are also legal consequences in cases of outright fraud. In 2017, a couple made up a story about a homeless veteran who gave them his last \$20 for gas. The couple later initiated a campaign on GoFundMe to help this veteran and quickly collected over \$400,000 in fewer than three weeks. This inspiring story quickly proved false, as the couple admitted using the funds for gambling, going on vacation, purchasing a car, and buying other luxury items. Both the veteran and the initiator eventually were subject to fines and prison time.<sup>7</sup>

## REWARD-BASED CROWDFUNDING

Unlike donation-based crowdfunding, backers of reward-based crowdfunding campaigns receive goods or services in return for their payments. Platforms like Indiegogo and Kickstarter provide arenas for initiators to present their projects and for contributors to fund these ventures. Although Indiegogo and Kickstarter were originally popular for funding music, art, and other creative projects, they have expanded into many other areas including technology, consumer products, and even video games.

Reward-based crowdfunding is gaining popularity among small entrepreneurs because it allows them to collect funds needed for project development and to incentivize their backers. The entrepreneurs do not have to give up their ownership stake to get their projects off the ground; instead, they can provide any rewards they deem appropriate, ranging from simple thank you notes, T-shirts, concert tickets, or the promised future delivery of products.<sup>8</sup>

It may surprise some entrepreneurs that the proceeds from reward-based crowdfunding campaigns are considered taxable business income instead of gifts. Such unwelcome tax consequences will be most relevant for entrepreneurs who are unable to use crowdfunding proceeds to offset start-up and routine expenses in the same year. In certain cases, entrepreneurs may also owe self-employment taxes in addition to income taxes. However, although the proceeds are usually considered taxable income, the amount can still be divided into part gift (nontaxable) and part sale (taxable income), similar to how a charity can sell a gala ticket at an above market value in a non-crowdfunding setting.

In June 2016, the IRS issued an information letter that provides general guidance regarding the taxability of crowdfunding contributions.<sup>10</sup> The letter indicates that general tax principles should apply because there are no existing court cases or revenue rulings that specifically address the tax treatment of crowdfunding activities. It also points out that crowdfunding proceeds received either for the provision of services or the sale of property are taxable, unless they are loans that need to be repaid, capital contribution in exchange for equity, or gifts. In most cases, the tax payment is due when income is in direct possession of the initiator. However, the IRS clarifies that if funds are credited to the initiator's account, set apart for him, or made available so he can withdraw anytime, income is "constructively" received and is also taxable.<sup>11</sup>

Successful entrepreneurial fundraising endeavors can bring surprising tax consequences, but failed projects are more likely to generate unpleasant legal concerns. Experienced practitioners advise initiators to be cautious and to treat the acceptance of backers' funds in exchange for rewards as a legal contract. As such, initiators need to be careful about the language used on their campaign pages, because they will be responsible for delivering the promised items or services.<sup>12</sup> If requested funds are raised but the initiator does not deliver the

products as promised, he or she can be sued for breach of contract. For example, in a recent case, an entrepreneur raised funds on Kickstarter for a hands-free I-Pad stand but failed to deliver the product to the backers. Although it appears the initiator was inexperienced and not intentionally fraudulent, a backer sued and eventually pushed the entrepreneur into bankruptcy.<sup>13</sup>

Besides the legal ramifications of unsuccessful projects between backers and initiators, recent federal and state level investigations have revealed several instances of fraud.<sup>14</sup> For example, the Federal Trade Commission (FTC) recently charged a Texas individual with operating a deceptive crowdfunding scheme. This individual campaigned on both Indiegogo and Kickstarter websites for the development of a hi-tech backpack but failed to deliver the product after raising \$800,000 and using most of the funds for personal expenses.<sup>15</sup> The FTC suggests potential backers ask questions and do their own vetting prior to committing funds, such as researching the initiators' track records of launching other products, understanding the alternatives for projects that do not go as planned, and having a clear idea of the development milestones.<sup>16</sup>

Besides tax considerations at the federal level, several state tax issues are also noteworthy. Chief among them are sales and use taxes.<sup>17</sup> Washington State was the first state to issue guidance addressing state sales and use tax implications of crowdfunding contributions.<sup>18</sup> According to their guidelines, the initiator needs to collect taxes if the rewards provided are typically subject to the state's sales and use taxes, such as meals (classified as retail services), digital products, or books and videos (classified as tangible personal property). These guidelines also allow taxpayers to split the contribution amount into sales and donations—the market value of the rewards received will count as a sale, and any amount above that will count as a donation.<sup>19</sup>

## EQUITY-BASED CROWDFUNDING

As the name suggests, backers receive ownership stake in return for their contributions in equity-based crowdfunding. Typically, when a company publicly releases shares in exchange for capital, the company must register the transaction with the Security and Exchange Commission (SEC) unless an exemption applies. The registration is a costly and time-consuming process that is prohibitively expensive for start-ups. Title III of the Jumpstart Our Business Startups Act of 2012 created a new exemption for internet-based security offerings, allowing non-accredited investors, generally investors with lower income and wealth levels, to participate in publicly advertised fundraising under certain investor protection provisions.<sup>20</sup>

The SEC adopted final rules in October 2015, which became effective in May 2016.<sup>21</sup> The most relevant provisions include offering amounts, channels, and investment dollar limits. The rules specify that a start-up can only raise up to \$1 million within a 12-month period through crowdfunding.<sup>22</sup> Companies cannot offer crowdfunding securities directly to investors; instead, the securities have to be offered through one of two types of intermediaries: a traditional broker-dealer or a "funding portal" registered with the SEC and a member of the Financial Industry Regulatory Authority.<sup>23</sup> Funding portals are websites that advertise investment opportunities and facilitate the payments from the investors to the issuers; however, the portals cannot provide investment advice to investors.<sup>24</sup> For a potential investor, if her income or net worth is less than \$100,000, she can invest the greater of \$2,000 or 5% of the lesser of her annual income or net worth. If both her income and net worth are more than \$100,000, she can invest up to 10% of her annual income or net worth, whichever is lower.<sup>25</sup>

Although crowdfunding offers investors opportunities to participate in early-stage ventures, there are considerable risks. For instance, the SEC warns about

the speculative nature of early-stage investments. Many initiatives eventually fail, and investors lose the entire investment. Besides the requirement that investors need to hold the securities for a year before resale, these investments could be highly illiquid and have limited secondary markets. The SEC also indicates that although the entrepreneurs in crowd-funded start-ups get to keep more equity, the trade-off is that they will not benefit from the professional guidance provided by venture capital firms or angel investors, who typically offer resources, contacts, and experiences in assisting early-stage companies to develop their businesses.<sup>26</sup>

In addition to the inherent risk and the recency of the SEC rules, the crowdfunding environment continues to develop, sometimes in response to other regulatory changes. For instance, the Tax Cuts and Jobs Act created "opportunity zones" (OZs) and provided tax breaks as investment incentives. OZs are designated census tracts throughout the country that are generally located in distressed communities characterized by underdevelopment. To encourage taxpayers to invest and keep their funds in OZs, taxpayers benefit from delayed or exempted capital gains tax payments after certain years.

Several real estate-focused platforms, such as Fundrise, RealCrowd, and Crowdstreet, started crowdfunding projects to buy properties eligible for the OZ tax breaks.<sup>27</sup> However, although some individual investors in crowdfunding OZ projects do benefit from investing alongside other accredited investors to mitigate the investment risks, the OZ idea itself is both original and controversial. On the one hand, the OZ projects channel desired investments such as small businesses and affordable housing into the most needed areas. On the other hand, some argue that certain developers and investors exploit the tax break and invest in the projects they would have undertaken anyway, which simply increases the price levels in the area and crowds out local residents during the gentrification process.

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## SIMPLE AGREEMENT FOR FUTURE EQUITY (SAFE)

In 2013, Y Combinator, a popular Silicon Valley start-up accelerator, created the Simple Agreement for Future Equity (SAFE), which is an agreement between an investor and a start-up where the company promises to provide equity to the investor if certain triggering events (discussed below) occur. The growth of equity-based crowdfunding quickly makes it a popular option for investing in start-ups or early-stage companies.<sup>28</sup> As of December 2018, a quarter of crowdsourced funds were offered through SAFEs, trailing equity offerings (42%) and debt offerings (30%).<sup>29</sup>

Many inexperienced investors identify the features of SAFEs as similar to those of convertible debt, an established instrument where an investor loans money to a company, with the possibility of converting to equity during the term of the loan. These two securities are both popular ways to invest in early-stage companies as they allow entrepreneurs to avoid giving up shares immediately and to delay assigning an explicit value to their company. In addition, they are both agreements between the investor and the start-up where the company promises to give the investor a future equity in the company if certain conditions (triggering events) take place.<sup>30</sup> The triggering events, which could be different across agreements, typically include change of control (meaning that the company is acquired by or merged with another company), initial public offering of the company's securities, or another round of financing involving equity securities.<sup>31</sup>

However, there are major differences between convertible debt and SAFEs. During the term of the contract, convertible debt investors receive interests and repayment of the principal if triggering events do not happen. If a triggering event occurs before the contract expires, investors convert their debt to equity at a discounted ratio, essentially receiving more shares.<sup>32</sup>

Despite the name, the SEC cautions that SAFEs may be neither simple nor safe. First, SAFE investors get a promise that the company will grant equity if certain

triggering events take place. However, it is important to bear in mind these “triggers” may never happen. For example, if the company is successful and never needs to initiate another round of financing, the SAFE would not convert to equity.<sup>33</sup> In this event, the investors would lose their entire investment.<sup>34</sup>

Besides the triggering events, investors also need to understand the conversion terms (how much equity the SAFE converts), the repurchase rights (whether the SAFE allows the company to repurchase investors' future rights), the voting rights (whether investors can vote on issues pertaining to the SAFE), and the dissolution rights (what happens to the SAFE if the company dissolves).

## SAFE TAX TREATMENT: DEBT, EQUITY, OR DERIVATIVES?

The unique features of SAFEs prompt the debate about how this innovative investment vehicle is taxed. Most practitioners agree that SAFEs are not the same as debt security because they do not have a maturity date and do not accrue interest. They also point to the fact that SAFE investors generally do not have the same protections as debt holders in a liquidation event.

However, not treating SAFEs as debt security does not naturally mean that SAFEs are an equity instrument. Some practitioners believe that for federal income purposes SAFEs should be taxed as derivatives or, more specifically, variable prepaid forward contracts.<sup>35</sup> In a transaction involving a prepaid forward contract, the buyer of the contract pays the seller the purchase price at the time when the parties enter into the contract, and, on a later date, a variable amount of property transfers to the buyer at the closing of the contract, which is similar to the way a SAFE functions.

Under this comparison, because no property is sold on the day when the investor makes the SAFE payment, there is no tax due, and the payment is treated as a deposit. The payment on this day, however, does determine the taxpayer's basis of stock. If the triggering event happens later and the taxpayer receives stock, it is also a

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nontaxable event but the taxpayer's holding period begins on this date. This date is important for taxpayers who may benefit from holding the stocks for long periods.<sup>36</sup> Finally, the taxable event occurs when the taxpayer sells the stock and realizes capital gains, which is the difference between the sales price and the SAFE payment.

An alternative view believes that SAFEs should be treated as equity. If this is the case, the taxpayer's basis of stock is determined on the date he purchases the SAFE, similar to the derivatives case above. What is different is that the holding period also begins on this date instead of the conversion date. This is beneficial to the investor, because the clock calculating the holding period starts early, qualifying the investor for favorable tax treatment sooner. However, even practitioners who support equity treatment of SAFEs consider its tax attributes a continuum, depending on specific facts and circumstances, instead of a set classification. The more certain the SAFE's triggering event will happen, the stronger the support for treating the SAFE as equity. For instance, if a SAFE is issued when equity financing is highly likely in the near future, then the SAFE strongly resembles equity rather than a derivative.

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## SAFE 2.0

As SAFEs gain popularity, more start-up companies use them to raise larger sums and at later stages of their development.<sup>37</sup> As a result, the need for clarifying its tax treatment has intensified. Y Combinator issued updated SAFE templates in September 2018, including more equity-like features than the 2013 version.<sup>38</sup> First, these updated SAFE templates provide investors rights to receive dividends when cash dividends are paid on outstanding shares of common stocks. In addition, in the event of liquidation, the SAFE holders' priority of receiving funds comes after debtholders, on par with preferred stocks, and ahead of common stockholders. Finally, the updated SAFE templates include language indicating that a SAFE is intended to be characterized like common stocks and that the parties agree to treat the SAFE as equity.

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## CONCLUSION

From music and art ventures, to real estate investments, to medical and legal services, the variety of projects on crowdfunding websites is unbounded. Crowdfunding platforms create great venues for people experiencing hardships to get financial help, entrepreneurs to realize their business plans, or small investors to access fascinating start-up ideas, all by collectively gathering funds.

Although the landscape of crowdfunding is still evolving, the tax treatment of funds generated through such platforms heavily depends on the type of crowdfunding and the considerations backers receive in return. When there is no specific guidance pertaining to the tax treatment of crowdfunding, it is always prudent to follow general tax principles.

In addition, the widely decentralized nature of funds implies highly dispersed control by funders, which generates legal concerns from a consumer or investor protection perspective. Multiple federal and state government agencies have started to prosecute cases involving fraud and are offering investor education resources, providing due diligence considerations, and evaluating ways to improve legislation.<sup>39</sup> For now, the best practice is to understand the risks and rewards of devoting funds to crowdfunding projects, including tax considerations.

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## ENDNOTES

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2. Cheryl T. Metrejean and Britton A. McKay, "Donation-Based Crowdfunding and Nontaxable Gifts," *Journal of Accountancy*, March 1, 2018, <http://bit.ly/2PI4bB8>.
3. IRS, Private Letter Ruling, Release Number: 201814009, April 6, 2018, <http://bit.ly/2Vz8ouS>; EY (Ernst and Young), "Crowdfunding Platform Provider Fails to Qualify as Section 501(c) (3) Organization," EY, April 11, 2018, <https://go.ey.com/39tde08>.

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11. For constructive receipt doctrine, see Section 1.451-2 of the Income Tax Regulations.

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13. Eric Markowitz, “When Kickstarter Investors Want Their Money Back,” *Inc.* Jan. 10, 2013, <http://bit.ly/38e6qCU>.

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16. FTC, “Understanding Crowdfunding,” FTC Consumer Information, Oct. 2019, accessed Jan. 23, 2020, <http://bit.ly/2Tw7Cfl>.

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19. See an example in Gruba, McAfee, and Ashby, “Crowdfunding Contributions and State Sales and Use Taxes.”

20. Vladimir Ivanov and Anzhela Knyazeva, “U.S. Securities-based Crowdfunding under Title III of the JOBS Act,” U.S. Securities and Exchange Commission, White Papers, Feb. 28, 2017, <http://bit.ly/2TAMDli>.

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22. This amount and investors’ income and net worth amounts are subject to inflation adjustments.

23. “Types of Crowdfunding and Regulations,” VentureWell, accessed Feb. 17, 2020, <http://bit.ly/32GX94W>.

24. “Investor Education: Crowdfunding,” Utah Department of Commerce, Division of Securities, accessed Feb. 17, 2020, <http://bit.ly/2wVL7J9>.

25. For instance, for an investor with an income of \$30,000 and a net worth of \$105,000, her income is less than her net worth, thus 5% of her income is \$1,500. She can invest the greater of \$2,000 or \$1,500, which allows her to invest \$2,000. On the other hand, if her annual income is \$150,000 and her net worth is \$80,000, the greater of \$2,000 or 5% of \$80,000 is \$4,000; as a result, her upper investment limit is \$4,000. The value of a taxpayer’s primary

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27. Noah Buhayar and David M. Levitt, “Crowdfunding Meets Tax Benefits as Fundrise Seeks \$500 Million,” *Bloomberg Law*, July 19, 2018, <https://bloom.bg/3czjfls>.

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33. Joseph M. Green and John F. Coyle, “Crowdfunding and the Not-So-Safe SAFE,” *Virginia Law Review Online*, 102, no. 168, (Dec. 2016), <http://bit.ly/2VFK1LR>.

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36. At the time of realization, if the taxpayer has been holding the stock for over a year, his gains qualify for long-term capital gains treatment at a reduced rate. If the company stocks are qualified small business stocks (typically a domestic C corporation with no more than \$50 million of gross assets and 80% of assets used in active trade or business) and the taxpayer holds the stock for over five years, at least 50% of the capital gains can be excluded. See Section 1202 of the Internal Revenue Code.

37. Y Combinator still considers the updated SAFE as a financing tool before the start-ups approach venture capital for larger sums of investments. However, Y Combinator also thinks of the updated SAFE as its own round of financing now.

38. Lesley P. Adamo, “Potentially Improved Tax Treatment of the New Post-Money SAFE,” Lowenstein Sandler LLP, April 9, 2019, <http://bit.ly/3akbgQo>.

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