Taxing Times

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CROWDFUNDING AND INCOME TAXES

Are you looking capital for your startup?

Crowdfunding has grown into a prominent internet-based vehicle for raising money from a large number of people who may have little in common other than a desire to contribute to the success of the project or other endeavor. On websites such as kickstarter.com and indiegogo.com, "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 fundraisers for

Thousands of businesses and individuals have succeeded in attracting funding through these sites, but often with little thought to the ramifications for income taxes. Congress and the IRS have not addressed crowdfunding income specifically, leaving scant guidance for CPA tax advisers whose clients may have this source of income. Consequently, there are few, if any, definitive guidelines, especially in view of the variety of types of arrangements and transactions that crowdfunding has taken so far, with still more options likely to come. Still, applying common tax principles and common sense may help tax preparers and advisers in talking through the issues with their clients who have taxable crowdfunding income and deciding how to report and pay taxes on it. This article provides some points to cover and related considerations.

TYPES OF CROWDFUNDING

Crowdfunding in the United States falls into three distinct types: for creative enterprises, which can be characterized as reward-based crowdfunding; as a means of personal fundraising, or donation-based crowdfunding; and equity-

Reward- and donation-based crowdfunding use third-party payment processing for collecting money. Both PayPal and Amazon Payments provide these services for crowdfunders. Each service has slightly different rules, but both comply with the U.S. Patriot Act data-collection requirements, and both work with the IRS. A campaign creator who collects over $20,000 and has 200 transactions in a year will receive a Form 1099-K, *Payment Card and Third Party Network Transactions*, reporting unadjusted gross revenues.

While pledges received from donation -based crowdfunding are likely to be considered nontaxable gifts, reward-based crowdfunding is likely to carry income tax ramifications for the project creator. Those tax consequences are the focus of this article.

INCOME TAX CONSEQUENCES

While both Kickstarter and Indiegogo mention taxes on their webpages, neither provides definitive information on reporting crowdfunding income and paying taxes. Indiegogo simply notes that taxing authorities may classify funds raised as taxable income to the campaign owner and any beneficiary (Indiegogo "Terms of Use," available at indiegogo.com.

Kickstarter states that it cannot give tax advice but indicates that in the United States, funds raised through campaigns on Kickstarter will generally be considered income (see "Kickstarter

The Internal Revenue Code and IRS guidance do not address crowdfunding, leaving several possibilities for how it should be treated for tax purposes. Accordingly, the following should not be regarded as a definitive guide but only as considerations in exploring each taxpayer's situation to assess possible tax treatments and, hopefully, settle on a well-reasoned and substantiated position. Also, note that crowdfunded activities may be subject to other taxes, notably, sales and use taxes. See "Tax Clinic: Crowdfunding Contributions and State Sales and Use Taxes," *The Tax Adviser*, June 2015, page 420.

TAXABLE INCOME

Amounts received through reward-based crowdfunding campaigns most likely are taxable income under Sec. 61, to be reported by the creator in the year of receipt. While not determinative of federal income tax, Washington state guidance indicates crowdfunding income may be subject to state excise, sales, and/or business and occupation tax (Tax Topics, available at dor.wa.gov. In August 2013, the Canadian Revenue Authority interpreted Canadian tax law as generally requiring inclusion of reward-based crowdfunding in Canadian taxable income where receipts are "by virtue of a profession or carrying on a business" (available at taxinterpretations.com.) If, by analogy, tax practitioners conclude that a client's crowdfunding income is includible in U.S. federal gross

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That depends on several factors, including:

- Whether the crowdfunding activity is deemed a trade or business or a hobby;
- Whether the activity is deemed a startup business;
- The method of accounting used by the creator; and
- The value of rewards given to backers

TRADE OR BUSINESS VS. HOBBY

If the activity is deemed a trade or business, all otherwise allowable trade or business expenses should be deductible against the income (Sec. 62). If, however, the activity is deemed to be a hobby, only expenses to the extent of the income will be deductible (Sec. 183).

Whether an activity is a trade or business or a hobby is a facts-and-circumstances determination. The Sec. 183 limit can apply to individuals, partnerships, S corporations, estates, and trusts; it does not apply to C corporations. Nine factors are See "Tax Practice Corner: Business or Hobby? The Nine Factors," *JofA*, Oct. 2013, page 71, for a discussion of these factors and their application.

STARTUP TRADE OR BUSINESS

If the crowdfunding activity is a new business, creators may have startup costs or, in the case of an activity set up as a corporation or partnership, organizational costs.

A taxpayer must capitalize these costs unless the taxpayer makes an election under Sec. 195 for startup costs or Sec. 248 (corporations) or Sec. 709 (partnerships) for organizational costs to deduct up to $5,000 of these costs (reduced by the amount by which they exceed $50,000). The deduction is taken in the year the trade or business becomes active (for startup costs) or the partnership or corporation begins business (for organizational expenses), and the remainder of the startup costs are amortized over a 15-year period beginning in the month in which the trade or business becomes active or the corporation or partnership begins business. A taxpayer is deemed to make the election to deduct and amortize these expenses unless it affirmatively elects to capitalize them on the return in which the trade or business activity begins or the entity begins business. For startup or organization costs to be deducted at all, the activity must be considered an active business. Court decisions on when a taxpayer becomes

Generally, this depends on the facts and circumstances—but conducting a crowdfunding activity alone may not be considered engaging in an active business, so crowdfunding expenses may not be deductible until a later year, when the business begins its active business.

ACCOUNTING METHOD: TIMING OF INCOME AND EXPENSES

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 is 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 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. Creators can plan to end their campaigns early in the year so some, if not all, of the expenses of their project will be incurred during the same year.

VALUE OF REWARD GIVEN TO BACKERS

"I have some really great news. I'm available for the opening in your company."

For example, a Kickstarter project that developed a "playhouse" for cats offered not only a set of blocks to build the structure but, at lesser levels of funding, a picture of cats with the backer's name and lifetime entry to the creator's office in Amsterdam to "cuddle" with cats there.

If the value of any of the rewards offered cannot be determined, or if a reward is determined to have no value or a value less than the pledge amount, additional evaluation may be required to determine whether all or part of the contribution can be classified as a nontaxable gift or some other type of contribution.

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NONTAXABLE GIFT

On its "Guide for Your Accountant" webpage mentioned above, Kickstarter indicates that certain funds raised through a crowdfunding campaign might be classified as a nontaxable gift (Sec. 102). A gift is generally defined for federal income taxes as an amount transferred out of

Gift treatment would be disallowed where the reward has a value approximately equal to or greater than the contribution in return for the payment (*American Bar Endowment*, 477 U.S. 105 (1986)).

Therefore, amounts received as a reward-based crowdfunding campaign that promises a reward that has *some* value is unlikely to be considered a gift. Contributions from backers who choose to forgo the reward might be treated as nontaxable gifts, but the exact circumstances of the contributions must be considered.

NONSHAREHOLDER CONTRIBUTION

In the case of corporations, Sec. 118 allows certain receipts to be treated as nontaxable contributions to capital by a nonshareholder. This is unlikely to apply to most reward-based crowdfunding, as most creators do not operate their campaigns through corporations.

If, however, 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 nonshareholder contribution to capital. In *Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. 401 (1973), the Supreme Court required that the contribution meet five factors: (1) The asset must become a permanent part of the transferee's working capital structure, (2) may not be compensation for services rendered (or presumably for products received), (3) must benefit the transferee commensurately with its value, (4) ordinarily will be used to produce additional income, and (5) must be bargained for. While a crowdfunding contribution may meet some of the criteria, the last factor will likely prove problematic. 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.

SUPPORT AND GUIDANCE STILL UNCLEAR

While crowdfunding is becoming more common, tax support and guidance for campaign creators remain

unclear on many points. At a minimum, the treatment of funds generated through crowdfunding depends on the method of fundraising and the value of any reward offered. Once these are established, it appears likely many creators will be considered to operate a trade or business, with attendant issues of method of accounting. These could entail tax treatment of startup expenses, along with some potential problems of timing of income and expense recognition peculiar to the funding scheme that could cause unexpected difficulties for creators in fulfilling rewards.