Crowdfunding Tax Advice From the IRS

Dan Wright and Joe Wallin

If you are going to raise money through a crowdfunding campaign, you need to think through the tax consequences before you start.

You might have to collect sales taxes. You might also have to pay federal income taxes on the funds you raise, in the year in which you receive them. Because the financial magnitude of the tax consequences, you need to think through the tax consequences to properly plan and budget your campaign.

The IRS has yet to issue significant and meaningful guidance on these issues specific to the new world of online crowdfunding. So when we saw that the IRS had issued an Information Letter on the topic, we were excited. We thought we might at last learn something interesting or meaningful.

The Trouble with Crowdfunding

The trouble with determining the taxes on a crowdfunding campaign can be the variety of things occurring in the campaign.

For example, in exchange for funds, the contributor might be entitled to equity in a new or existing company, products, services, loan repayment, or just nominal awards or acknowledgements. In some cases, nothing is exchanged; the contributor simply makes a gift in the interest of supporting a worthy or novel effort. In other cases, the funds are required to be returned to the contributor if the purpose of the fund raise fails to materialize.

The IRS Information Letter

The Treasury Department published the Information Letter (***Information Letter 2016-0036***) on March 30, 2016. The letter is exciting to start reading, because the question posed is pretty interesting:

> What are "the income tax consequences of a crowdfunding effort to purchase a company through contributions for which the contributors will receive...."

And then the story trails off. The IRS doesn't tell us what was being given in exchange. This makes it hard on us as readers.

If the recipients were receiving equity in the company, their contributions would generally not be taxable income. Corporations can issue stock for cash without income (IRC Section 1032).

Similarly, contributions of cash to an LLC taxed as a partnership in exchange for interests in the LLC are not taxable (***IRC Section 721***).

But what happens if the contributors are receiving equity in the company, ***and*** receiving some spiffs as well. For example, what if the company being purchased was a restaurant, and all of the investors received 15 free dinners a year? What then?

General Tax Principles Apply

The IRS says general tax principles apply to the receipt of funds.

In general, money received without an offsetting liability, that is neither a capital contribution to an entity in exchange for a capital interest in the entity, nor a gift, ***is*** includable in income.

What this means is that crowdfunding revenues will generally be treated as taxable income if the revenues are not 1) loans that must be repaid, 2) a contribution to equity in exchange for an equity interest in a company, or 3) gifts. The letter noted that some transfers without a "quid pro quo" attachment are not necessarily gifts for income tax purposes, but did not further elaborate on when a crowdfunding "gift" is not taxable revenue.

Clearly, the IRS will treat the funds as revenue when the funds are contributed in exchange for services, or for a product. The letter also touches on *when* the funds must be reported. With respect to timing, the letter cited general "constructive receipt" principles. That means that the revenue must be reported in the period in which possession of the funds is no longer subject to "substantial limitations or restrictions." A self-imposed restriction doesn't defer recognition of that income.

Request a Ruling?

Finally, the letter invites fund recipients to request a "private letter ruling" from the IRS regarding their specific facts. While the private letter ruling process can be helpful in some circumstances, this process can involve significant preparation cost and generally takes considerable time before a response is received, particularly when arrangements are new or unconventional.

The letter leaves most crowdfunding recipients in the position of applying very general tax principles to their respective arrangements. Given that many crowdfunding arrangements are new and in some cases novel, applying general principles can be difficult, and will likely leave taxpayers subject to audit risk. It would be great if the IRS issued more guidance in this area.