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TAX CONSEQUENCES OF CROWDFUNDING

Startup Blog Alert
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Websites like Kickstarter and Indiegogo provide entrepreneurs with a great platform to accept donations to jumpstart a business. Not only can these crowdfunding platforms provide cash, but they can also provide validation for a startup idea and business model. Many of our clients have used these platforms with great success. But crowdfunding isn't free. In fact, there can be serious tax consequences to a successful campaign.

Most crowdfunding campaigns fall into one of three categories: reward-based crowdfunding, donation-based crowdfunding, and equity based crowd-funding. This post will focus on reward- and donation-based crowdfunding.

Pledges received from donation-based crowdfunding campaigns are likely to be considered nontaxable gifts. A gift is generally defined for federal income taxes as an amount transferred out of "detached and disinterested generosity."[1] The IRS website defines a gift as money a donor gives "without expecting to receive something of at least equal value in return."[2] Therefore, many pledges raised through reward-based crowdfunding are most likely taxable income and must be reported by the startup in the year of receipt.

If the value of the reward cannot be determined, or if a reward has less value than the pledge amount, additional evaluation may be required to determine if part of the pledge can be classified as a nontaxable gift. Consider a crowdfunding campaign to develop an eco-friendly dog toy. The campaign might offer the finished product as one reward, a picture of a dog at a lesser level of funding, and lifetime entry to the founder's office in Omaha to play with the company's dogs. Although the value of the dog toy can be easily determined, the other rewards are not as simple.

The timing of a crowdfunding campaign can lead to complicated tax issues. Consider an entrepreneur that runs their campaign in December but manufactures and ships the product in February. That leaves the entrepreneur with business income in year one and major expenses in year two. This timing issue can cause larger-than-expected tax bills at a very inconvenient time. This issue might be avoided through accrual-based accounting. However accrual-based accounting is notoriously tricky and best left to an accountant.

Sales tax can be another issue. It's up to interpretation when a "sale" actually occurs in a crowdfunding campaign. In some cases, sales tax may need to be collected in campaigns that take pre-orders. And the line between donations and pre-orders is

often very thin. Even worse, sales taxes for services and goods are assessed differently from state to state, especially when the goods and services are distributed digitally. Accounting for sales tax is something that needs to be addressed sooner rather than later.

Companies that raise over $20,000 with 200 or more transactions will receive likely receive a 1099-K after a successful crowdfunding campaign. Smaller projects are still taxable, but they will generally not create a 1099-K paper trail for tax authorities to follow. Regardless, a company can face penalties if it fails to properly claim crowdfunding proceeds.

There's three teachable points here. First, if you're running a crowdfunding campaign, you need a good accountant. And you need to help your accountant by keeping a detailed record of all expenses from the very beginning of your startup. Second, be careful when selecting your rewards. The type and value of these rewards will have tax consequences. Third, if you're running a crowdfunding campaign, factor in a bit of extra cushion in your business plan for taxes.

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[1] Duberstein, 363 U.S. 278 (1960).

[2] https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Gift-Tax