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Amending Nontaxable Crowdfunding Reporting Requirements

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Graham, Swafford, and Smith propose an update to Form 1099-K for funds received by a payment processor as part of a donation- or gift-based crowdfunding campaign for a social, civic, charitable, or personal cause.

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I. Background

A. The Emergence of Crowdfunding

Around 2010, during the recession and government bailouts of corporate banks and automakers, a type of social-civic "bailout" by private citizens known as "crowdfunding" emerged. According to the website YouCaring, crowdfunding is defined as "the practice of funding a project or cause by raising money from a large number of people, typically through the internet. It is a form of peer-to-peer fundraising that harnesses the power of social networks to raise awareness and draw donations from around the world for online campaigns."[1]

Given the ease with which one can reach a large number of people using the internet, online crowdfunding has grown exponentially in recent years and has emerged as a common way for individuals to seek financial assistance from others. A 2016 Pew Research Center report found that about one in five Americans have contributed to an online fundraising campaign.[2] Three percent of Americans have established an online fundraising project.[3] The Pew Research Center report also says that 68 percent of donors have contributed to a campaign seeking to help a person facing a hardship or financial challenge.

According to the research firm Massolution, worldwide crowdfunding grew to $16.2 billion in 2014 — a 167 percent increase over the $6.1 billion raised in 2013.[4] In North America alone, crowdfunding volumes grew 145 percent, to $9.46 billion, in 2014. Solely donation- or gift-based crowdfunding grew 45 percent in 2014. Continuing the trend, the crowdfunding industry grew again in 2015, reaching $34.4 billion and more than doubling the previous year's volume.[5] This growth is expected to continue, and it has been projected that the global crowdfunding market will increase to between $90 billion and $96 billion by 2025.[6]

GoFundMe is the world's largest social fundraising platform and the top personal fundraising website.[7] Launched in 2010, the

[1] "What Is Crowdfunding?" YouCaring (2017).

[2] Aaron Smith, "Shared, Collaborative and on Demand: The New Digital Economy," Pew Research Center (May 19, 2016).

[3] *Id.*

[4] Erin Hobey, "2015 Massolution Report Released: Crowdfunding Market Grows 167% in 2014, Crowdfunding Platforms Raise $16.2 Billion," National Crowdfunding Association of Canada (Mar. 31, 2015).

[5] Salman SH, "The Global Crowdfunding Industry Raised $34.4 Billion in 2015, and Could Surpass VC in 2016," Dazeinfo (Jan. 12, 2016).

[6] Katherine Noyes, "Why Investors Are Pouring Millions Into Crowdfunding," *Fortune*, Apr. 17, 2014.

[7] "About Us," GoFundMe (2017).

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company has helped raise more than $4 billion through more than 40 million donors.[8] People have raised more money on GoFundMe than through any other crowdfunding website.[9] The largest online campaigns in 2016 arose from news events and natural disasters.[10] GoFundMe reports that in 2016, $9 million was raised for victims of the Pulse Nightclub shooting in Florida, $11.2 million was raised to support Louisiana flood victims, $3 million was raised to support Hurricane Matthew victims, and $7.8 million was raised to support Standing Rock protesters. According to the report, "starting a GoFundMe in response to pivotal moments has become part of our social fabric."

Other companies providing online platforms for fundraising include YouCaring, which acquired GiveForward; Fundly; Indiegogo; FundRazr; Kickstarter; iFundWomen; Rally.org; Custom Ink Fundraising; and others. These companies provide platforms for people to establish different types of online fundraising campaigns. Many campaigns seek gifts and donations for social, civic, charitable, or personal causes, while others seek funding for businesses, real estate, arts and entertainment, and the like. This paper focuses solely on the unintended tax consequences affecting people who establish crowdfunding campaigns to obtain gifts and donations for social, civic, charitable, or personal causes.

B. The Logistics of Crowdfunding

To create a crowdfunding campaign, someone goes to a crowdfunding company's website, such as GoFundMe, and creates a home page for the campaign that explains why financial assistance is needed in a specific situation. Relevant photographs and videos can be uploaded to advertise the campaign, and updates can be posted. The campaign may be shared through social media sites such as Facebook and Instagram, where friends, relatives, colleagues, and other members of the public can view the campaign's page and make donations in any amount. There is usually a fundraising goal, and the home page will track the campaign's progress toward that goal.

Donations received through the crowdfunding company's website are held in a separate, linked account by a third-party payment processor such as WePay or PayPal.[11] When someone wants to withdraw the funds, the payment processor transfers the money to that person's bank account.

II. The Problem for Crowdfunding Campaigners

A. The Unintended Problem

For crowdfunding campaigns whose purpose is to solicit gifts and donations for social, civic, charitable, or personal causes, an unintended problem has arisen. The IRS is serving audit notices on some taxpayers who receive funds from these crowdfunding campaigns, warning them that they are not accurately reporting all their income on their tax returns. This is because, under current law, the payment processor is required to issue a Form 1099-K for each person who receives funds from a crowdfunding campaign. The Form 1099-K categorizes the funds received through the crowdfunding campaign as income; however, the money received from the campaign exclusively comprises gifts and is therefore not taxable income.

B. Common Hypothetical Scenarios

1. Hypothetical No. 1: Medical and life expenses.

Tim, a young father of three children and the sole breadwinner of his family, is in a horrific accident. While riding his bike, he is hit by a car and left paralyzed from the neck down. He cannot return to work, support his family, or pay his massive medical bills. Tim establishes a crowdfunding campaign through GoFundMe to seek donations for financial assistance. The campaign receives donations totaling $28,000, with individual donations ranging from $100 to $1,000 from 250 individuals. Tim uses the money to pay for living expenses and redesign his home to be handicap-accessible. Tim and his wife file

[8] *Id*.

[9] *Id*.

[10] "Giving Report 2016," GoFundMe (2016).

[11] "How Do Withdrawals Work?" GoFundMe (2017).

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their federal income tax return, which includes all earned income for the year but not the money received from Tim's crowdfunding campaign. Later, Tim and his wife receive a notice from the IRS claiming there is a discrepancy between the income reported on the family's tax return and that reported by WePay in connection with the GoFundMe crowdfunding campaign.

2. Hypothetical No. 2: End-of-life care and funeral expenses.

Stella and Matt graduate from law school and get married. Both have hundreds of thousands of dollars of student loan debt, and they have little to no money of their own. They start new jobs as young associate attorneys, but soon thereafter, Stella is diagnosed with cancer. Matt must stay home from work to care for Stella, who passes away six months later. Their friend Rob establishes a FundRazr campaign to seek donations for Matt and Stella's living expenses and Stella's caregiving and funeral expenses. The campaign receives donations totaling $40,000 from 300 individuals, with each donation ranging from $100 to $1,500. Rob withdraws the funds from the account and gives the money to Matt. After filing his income tax return, Rob receives a notice from the IRS stating that there is a discrepancy between the income he reported on his tax return and that reported by PayPal in connection with the crowdfunding campaign on FundRazr.

3. Hypothetical No. 3: Humanitarian expenses.

Kristen wants to go on a mission trip to Cambodia with her church. She establishes an Indiegogo campaign to seek donations to help pay for the cost of her trip, as well as for medical supplies, food, and clothing for the people she will be helping in Cambodia. The campaign receives donations totaling $21,000 from 275 individuals, with individual donations ranging from $50 to $1,000. After filing her income tax return, she receives a notice from the IRS stating that the income she reported is inconsistent with that reported by PayPal in connection with the Indiegogo crowdfunding campaign.

III. Legal Analysis: Section 6050W

Why are people like Tim, Rob, and Kristen receiving IRS notices assessing income tax, along with interest and penalties, on the crowdfunding donations if the funds received from their crowdfunding campaigns are nontaxable gifts? Clearly, this is a mistake — an unintended consequence of a law that predates the emergence of crowdfunding.

A. Section 6050W

In 2008 Congress passed the Housing and Economic Recovery Act of 2008,[12] which enacted section 6050W. Section 6050W imposes annual reporting requirements on any payment settlement entity or third-party payment processor that makes or processes payments on behalf of an individual payee.[13] Section 6050W provides that each "payment settlement entity shall make a return for each calendar year setting forth (1) the name, address, and TIN of each participating payee to whom one or more payments in settlement of reportable payment transactions are made, and (2) the gross amount of the reportable payment transactions with respect to each such participating payee."[14] In other words, the payment processor must complete a Form 1099-K for each payee-taxpayer and report the payee-taxpayer's identity, the gross amount of payments processed, and the number of transactions. A "reportable payment transaction" is "any payment card transaction and any third-party network transaction."[15]

Note that a de minimis exception is provided, under which a payment processor is not required to report unless the gross amount of funds received by the payee is more than $20,000 and the aggregate number of transactions exceeds 200.[16] A payee must meet both the amount and quantity tests to trigger the issuance of a Form 1099-K.

[12] H.R. 3221.

[13] Payments to corporations are generally exempt. Joint Committee on Taxation, "Housing and Economic Recovery Act of 2008 (P.L. 110-289) (Division C — Housing Assistance Tax Act of 2008)," JCX-63-08 (July 23, 2008).

[14] Section 6050W(a).

[15] Section 6050W(c)(1).

[16] Section 6050W(e).

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B. Legislative History

The legislative history behind section 6050W indicates that the law was not likely intended to target crowdfunding campaigns that raise money for social, civic, charitable, or personal causes. Instead, the purpose of the law was to assist the IRS in comparing payee gross proceeds from card sales with gross receipts reported on the taxpayer's return.[17] The new rules enabled targeting of individual small business merchants who incorrectly report taxable gross income by ensuring that the amounts being reported by those merchants match the amounts the payment processors report as having been distributed to the merchants. For example, if a business sells items online and accepts merchant payment cards, the business will receive a Form 1099-K for the gross amount of proceeds for the goods purchased through use of a merchant payment card in that calendar year.

C. The Modern Application of Section 6050W

Since section 6050W was enacted before the rise in crowdfunding, the law is now capturing a wider-than-intended taxpayer base. Rather than applying only to small business owners, section 6050W also targets individuals who are not actively pursuing or engaged in a trade or business but are instead using payment processors to receive online gifts or donations.

When the gross amounts are reported on Form 1099-K by the payment processor, they are classified as the payee-taxpayer's income because there is no mechanism for indicating otherwise. Accordingly, in the hypothetical scenarios addressed above, the payment processor issued a Form 1099-K each to Tim, Rob, and Kristen as payee-taxpayers, prompting the IRS to erroneously assume they did not report all their taxable income.

The funds a payee receives from her donation- or gift-based crowdfunding campaign are gifts and are therefore not taxable income. Gross income does not include the value of property acquired by a gift.[18]

There is no mechanism in place to effectively communicate the true nature of a crowdfunding campaign's funds and their ultimate recipient. To the IRS, upon receiving the reported information from the payment processor, it seems like the payee-taxpayer is engaging in a business and failing to report all income. If there is conflicting information on Form 1099-K and the taxpayer's income tax return, the IRS may threaten to assess tax liabilities and underpayment penalties and consequently audit the payee-taxpayer. Not only does this cause the payee-taxpayer unwarranted stress and expense during what is often a sensitive period of her life, but it is also an unproductive use of IRS resources because any investigation will undoubtedly conclude that the money received was property acquired as a gift and was therefore correctly excluded from the calculation of gross income.

Further, another unintended consequence can result: The payee-taxpayer reported on Form 1099-K is not necessarily the individual receiving the funds raised by the crowdfunding campaign. In many cases, individuals create crowdfunding campaigns on behalf of others in need. In Hypothetical No. 2 above, Rob established the crowdfunding campaign for Stella's expenses and Matt received the money, but Form 1099-K was nevertheless issued to Rob. Rob didn't receive the benefit of the funds donated by the campaign, yet the IRS is inquiring about his income taxes. Therefore, not only are the funds being erroneously categorized as taxable income, but the purported taxable income may be attributed to the incorrect taxpayer.

D. No Practical Remedies Proposed Thus Far

The IRS has not addressed the relationship between donation- or gift-based crowdfunding and payment processors. It has not offered guidance regarding section 6050W except for a

[17] *See* Treasury Inspector General for Tax Administration release on how enforcement actions for payment card reporting requirements could reduce the tax gap (Nov. 24, 2015).

[18] Section 102.

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recent information letter focusing on the tax consequences of equity-based securities crowdfunding.[19] The information letter briefly states that "crowdfunding revenues generally are includible in income if they are not (1) loans that must be repaid, (2) capital contributed to an entity in exchange for an equity interest in the entity, or (3) gifts made out of detached generosity and without any 'quid pro quo.'" However, the information letter instructs taxpayers that "the income tax consequences to a taxpayer of a crowdfunding effort depend on all the facts and circumstances surrounding that effort," and that "a taxpayer may request a private letter ruling from the Internal Revenue Service that applies the law to the taxpayer's particular facts and circumstances."

The IRS is essentially suggesting that the payee-taxpayer wait for an IRS audit or obtain a private letter ruling. This is not a realistic, practical, or fair solution for donation- or gift-based crowdfunding campaign payees. Both options could be costly and stressful for the payee-taxpayer, who typically is a person in need or is acting on behalf of such a person. It is unfair to subject the payee-taxpayer to these processes when the crowdfunding money is patently not taxable income. It would be better for both the IRS and the payee-taxpayer if the IRS addressed the issue upfront when a crowdfunding campaign is established.

Note that WePay has taken the position that, as of 2015, the IRS has provided sufficient guidance that WePay is not required to send a Form 1099-K for payments made solely as gifts or donations.[20] It has concluded that the purpose of Form 1099-K is to report payments for the provision of goods or services, which may be subject to tax. Because gifts and donations typically are not reported as income by recipients, WePay states that it is not necessary to send them a Form 1099-K. This position regarding the issuance of a Form 1099-K for payments made solely as gifts or donations is exclusive to WePay, and there are no public IRS rulings or guidance that support this determination. Therefore, a solution for the general issue at hand is still necessary.

IV. The Proposed Solution

A. Form 1099-K and Self-Certifying Declaration

We propose a simple, cost-effective solution to the problem facing donation- or gift-based crowdfunding campaigners. We don't propose to modify section 6050W or enact a new statute. Rather, we recommend that Form 1099-K be updated and payee-taxpayers be required to sign a self-certifying declaration that the funds received from the payment processor are gifts that will be excluded from taxable income.

Form 1099-K should be updated to provide a new election box stating that the funds received by the payment processor are gifts from a donation- or gift-based crowdfunding campaign. This would allow payment processors to continue to complete Form 1099-K, as required by section 6050W, but show the IRS that the funds received are gifts and are not taxable income.

The payee-taxpayer should declare under penalty of perjury on the self-certifying declaration that the amounts received from the crowdfunding campaign and reported on Form 1099-K are gifts and are excluded from taxable gross income. This would indemnify the payment processors and relieve them of the liability associated with making the determination of whether the funds in an account should be included in the payee-taxpayer's taxable income

B. Analogous to Retirement Plan Rollovers

This would not be the first instance of amounts reported on a Form 1099 being excluded from gross income. When a taxpayer rolls over a retirement plan distribution, he generally does not pay tax on it until he withdraws it from the new plan.[21] Although the transaction is nontaxable, a Form 1099-R is issued in connection with the rollover, and the taxpayer must still report it to the IRS. The Form 1099-R indicates to the IRS that the money was never in the taxpayer's hands because of the rollover to another

[19] INFO 2016-0036.

[20] "How Will Using WePay Affect My Taxes?" WePay (2017).

[21] IRS, "Rollovers of Retirement Plan and IRA Distributions" (2017).

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retirement plan through the use of a distribution code on the Form 1099-R.

The proposed revisions would create a similar sequence of events: The taxpayer-payee would submit to the payment processor the self-certifying declaration stating that the amounts received from the account are gifts to be excluded from taxable income. The payment processor would rely on that declaration to indicate on Form 1099-K that the funds remitted to the payee are gifts. When the IRS receives the Form 1099-K, it is notified that the amount reported is not taxable income.

C. Consistent With Legislative Intent

The proposed revisions comply with the legislative intent behind the enactment of section 6050W. The revisions don't interfere with the purpose of section 6050W to allow the IRS to more effectively monitor individual small business owners who are required to report the income they receive from payment settlement entities and third-party payment processors. The IRS would continue to be able to reconcile the amount reported on a taxpayer's income tax return with Form 1099-K. The proposed revisions don't affect other laws, but simply seek to fix the existing mechanism to properly report and account for transactions subject to enforcement under section 6050W.

While the WePay position described above regarding whether to issue a Form 1099-K to a payee-taxpayer is exclusive to WePay and not based on official IRS guidance, WePay's decision was made in reliance on communication with the IRS, which means that the IRS may be amenable to excluding funds from donation- or gift-based crowdfunding campaigns from the amounts reported on a taxpayer's income tax return.

The proposed revisions allow payee-taxpayers to address, at the beginning of the crowdfunding campaign process, the fact that the money received comprises only gifts. As a result, the payee-taxpayer would not be subject to unwarranted scrutiny by the IRS for failing to report amounts that are not taxable income.

Importantly, the proposed revisions would save precious IRS resources and time. The IRS should not expend its scarce resources on unmeritorious examinations or audits that lead to no recovery. Reducing the number of examinations conducted by the IRS decreases the administrative burdens associated with each review and frees up IRS resources to be used elsewhere, such as in situations in which the recovery of revenue is more likely and justified. Thus, the proposed revisions would have no negative impact on revenue because the funds being wrongly classified are not taxable income in the first place. If anything, the proposed revisions would increase revenue because the IRS would be able to devote more resources to other examinations that may result in a recovery.

Although the quantity of audits triggered by the discrepancies in income would be reduced, the proposed revisions do not limit the IRS's authority and ability to audit any payee-taxpayers as it deems appropriate. The proposed revisions simply provide a streamlined process for the payee-taxpayer to show, at the outset of the crowdfunding campaign process, that the amounts to be received are gifts and are not taxable income.

Finally, no additional training would be required for the IRS to implement the proposed revisions. In establishing an account for a payee-taxpayer, payment processors would need to modify their application process to include the payee's mandatory self-certifying declaration; however, this additional requirement should not be overly burdensome, and the responsibility would lie with the payee-taxpayer to complete the self-certifying declaration.

D. Doesn't Apply to Taxable Income

The solution proposed in this paper is intended to address donation- or gift-based crowdfunding campaigns for social, civic, charitable, or personal causes. It is not intended to apply to crowdfunding campaigns in which the payee-taxpayer receives taxable income. As discussed above, some crowdfunding campaigns are created to make a business investment. If a person signs the self-certifying declaration in those circumstances, she does so falsely, and the IRS is not precluded from pursuing appropriate remedies.

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V. Conclusion

In conclusion, the IRS should update Form 1099-K to include a new election box stating that the funds received by the payment processor are gifts received through a donation- or gift-based crowdfunding campaign. The payee-taxpayer should provide a self-certifying declaration whereby the payee-taxpayer declares under penalty of perjury that the amounts reported on Form 1099-K by the payment processor are gifts received from a crowdfunding campaign and should be excluded from taxable gross income. This solution is reasonable, practical, and cost-effective, and it would obviate unnecessary and unmeritorious investigations so that IRS resources could be devoted elsewhere. ■

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