Journal of Accountancy

Donation-based crowdfunding and nontaxable gifts

This growing means of contributing to causes and hardship relief requires special attention from recipients and their tax advisers.

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March 1, 2018

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Crowdsourced online donation projects have become hugely popular: A 2016 report from the Pew Research Center found that 22% of American adults said they had contributed to a crowdsourced fundraising project. Most donors (68%) contributed to help someone in need. And while the majority of crowdfunding contributions were quite small — 62% of donors gave no more than $50 to any project — the amount raised can grow quickly. However, these online campaigns raise a number of tax issues for people setting up a campaign and for beneficiaries.

Several types of crowdfunding exist, and the tax consequences of each can be different (see "Crowdfunding and Income Taxes (https://www.journalofaccountancy.com/issues/2015/oct/crowdfunding-and-income-taxes.html)," *JofA*, Oct. 2015). One of the most common types is donation-based crowdfunding. This article considers only donation-based crowdfunding, also known as personal crowdfunding or cause funding, discussing available guidance and how taxpayers and their tax advisers may plan for the income tax consequences of these campaigns (see also "Crowdfunding Brings New

Opportunities for CPAs (https://www.journalofaccountancy.com/issues/2015/oct/crowdfunding-opportunities-for-cpas.html)," *JofA*, Oct. 2015). The scope of this article is limited to U.S. taxation of donation-based crowdfunding and not foreign-based campaigns.

GENERAL INFORMATION ABOUT CROWDFUNDING

Crowdfunding is defined as "the activity or process of raising money from a large number of people, typically through a website, as for a project or small business" (dictionary.com). Specifically, donation-based crowdfunding "involves backers donating varying sums of money to support a specific cause or project. ... [T]he pledge is essentially a donation" (lexicon.ft.com).

The two other main types of crowdfunding are reward-based crowdfunding, where backers, or contributors, receive a good or service in return for their payment, and equity-based crowdfunding, where backers receive equity in return for their payment. In donation-based crowdfunding, backers typically receive nothing in return for their contribution.

GoFundMe, which claimed more than 50 million donors and more than $5 billion in total fundraising as of late 2017, specializes in donation-based crowdfunding, "enabling people to raise money for personal causes and life events" ("About Us" and press release, Jan. 13, 2015, gofundme.com). People use these campaigns to raise money for personal or social causes, from contributing to the cost of building a school in Somalia to helping to send someone's child to summer camp. Often, they are set up by friends and family members of the campaign beneficiary. One of GoFundMe's largest campaigns to date was set up to aid victims of the October 2017 mass shooting in Las Vegas. In its first 15 days, this appeal raised more than $10.8 million.

TAX PRINCIPLES

The IRS has issued little guidance in this area, leaving campaigners, taxpayers, and tax preparers concerned. The IRS did issue Information Letter 2016-0036 on June 24, 2016, although it pertains primarily to equity- or reward-based fundraising and constructive receipt of income. And, as the document states, information letters are not designed to address a specific set of facts but to provide general information.

Sec. 61 states that "gross income means all income from whatever source derived," unless specifically excepted. Statutory exceptions include the value of property acquired by gift (Sec. 102). A gift is given from " 'detached and disinterested generosity,' ... 'out of affection, respect, admiration, charity, or like impulses,' " and not from " 'any moral or legal duty,' or from 'the incentive of anticipated benefit,' " or "in return for services rendered" (*Duberstein*, 363 U.S. 278, 285 (1960) (internal citations omitted)). Depending on how a donation-based crowdfunding campaign is set up, amounts raised may qualify for gift treatment.

RELATED ISSUES

Information reporting by payers

Crowdfunding websites (donation-based as well as other types) may not always handle payment processing. Instead, this function may be contracted to a third-party payment processor. For example, GoFundMe.com uses WePay.com and Paypal.com (limited to certain fundraising for certified charitable campaigns) to process contributions and disbursements for U.S.- and Canada-based campaigns. Under

Sec. 6050W, payers are required to send a Form 1099-K, *Payment Card and Third Party Network Transactions*, to a payee who receives more than $20,000 and has more than 200 transactions during a calendar year. A copy of this form will also be sent to the IRS.

In requiring this reporting, Sec. 6050W(c) indicates that a "reportable payment transaction" is any transaction in which either a payment card is accepted as payment or the transaction is settled through a third-party payment network. A third-party payment network is defined as an agreement or arrangement where a substantial number of persons set up accounts with an organization where the agreement or arrangement provides for standards and mechanisms for settling transactions and guarantees payment to those providing goods or services. In addition, the persons who set up the accounts with the organization must be unrelated to the organization, provide goods or services, and agree to settle transactions for payment of those goods and services through the agreement or arrangement (Sec. 6050W(d)(3)).

Regs. Sec. 1.6050W-1(c)(3) restates the definition of a third-party payment network to clarify that it includes a substantial number of *providers of goods or services* who have agreed to settle transactions *for the provision of the goods or services* to purchasers through the network. In addition, the regulation further clarifies that participating payees (those who would receive the Form 1099-K) are persons who are providers of goods and services (Regs. Sec. 1.6050W-1(c)(3)(iii)). This is an important distinction when considering the reporting obligation of payment processors for donation-based crowdfunding websites, as the recipients of donation-based crowdfunding campaigns generally do not provide goods and services.

WePay has noted on its website that it received clarification from the IRS in 2015 that it is not required to send a Form 1099-K for payments made solely as gifts or donations (support.wepay.com (https://support.wepay.com/hc/en-us/articles/203609483-Tax-Reporting)). Since we could find no guidance issued by the IRS in 2015, we emailed Susan Dunn, general counsel for WePay Inc., to inquire about the clarification referenced on the company's website. The relevant portion of her response is shown below:

In 2015, WePay submitted a request to the IRS for a private letter ruling, that WePay is not required to file a Form 1099-K with respect to the processing of payments that are made solely as a gift or donation and not for the provision of goods and services. The IRS declined to issue the private letter ruling on the grounds that it would be a "comfort ruling" because it related to an issue that is clearly and adequately addressed by existing authority. [Email from Susan Dunn Feb. 22, 2017]

She further noted that after consultation with outside tax counsel, the company determined that it did not have to send Form 1099-K to recipients of gifts or donations. Although she did not specify what authority WePay based this position on, we believe it refers to Sec. 6050W and related regulations' requirement that Form 1099-K be issued to providers of goods or services (see above). Those who receive only gifts or donations do not provide goods or services, so payers are presumably not required to send Form 1099-K to these recipients.

Who characterizes the payment and how?

One issue that does arise with the conclusion that Form 1099-K is not required in this instance is who determines whether the amounts received are gifts or donations and how this determination is made. Because the law requires the payer to provide Form 1099-K if it is required, presumably the payer determines whether the amounts paid to a recipient are gifts, donations, or something else that may require reporting. Do the payment processors have a process for determining how to classify these payments? If so, what is a recipient's responsibility if the payer characterizes the payment incorrectly?

What if the IRS shows up?

We are thus aware that at least one payer has determined that it is not required to send Form 1099-K to recipients of gifts or donations. This may not solve the entire problem. Taxpayers may have received Form 1099-K for tax years that are still open for audit and adjustment.

Payment processors may misclassify a payment and send a Form 1099-K for a gift or donation. Or they may choose not to attempt to classify the payments and simply send Form 1099-K to all recipients to make sure they are complying with their requirements as a payer. Or the IRS could audit a recipient and find deposits that were not reported on the tax return. How does a taxpayer prepare for these possibilities?

As noted above, many crowdfunding campaigns are set up by friends or family of the person in need (the beneficiary of the campaign). However, the crowdfunding website will generally pay the funds to the person who set up the campaign, i.e., the agent, not the beneficiary, even though the beneficiary may be clearly defined on the website. The agent will transfer the funds to the beneficiary, who will usually spend the funds on whatever they were raised for (medical bills, etc.). If the IRS were to issue a notice of deficiency to the agent, that person generally would no longer have the funds. Usually, the beneficiary no longer has the funds, either. Payment of any tax assessed could become a significant hardship.

While we cannot find any specific data, anecdotal evidence suggests that the IRS is initially classifying all the receipts to the agent as income. We base this on several emails from tax advisers on behalf of clients and one from a taxpayer/attorney who acted as an agent for a friend and was involved in a dispute with the IRS. We believe a little forethought and planning will go a long way toward addressing many of these issues, with a better result for taxpayers. New guidance and rules from GoFundMe have helped alleviate both this issue and potential fraud, because there is a specific form and format for setting up a campaign to benefit another person (see support.gofundme.com (https://support.gofundme.com/hc/en-us/articles/204993267-How-do-I-create-a-campaign-on-behalf-of-someone-else-)).

POSSIBLE DEFENSES

Agency theory

Again, many donation-based crowdfunding website campaigns are set up by a friend or family member of the beneficiary. These individuals may be acting as an agent for the eventual recipient (the beneficiary). Under agency theory, the agent is not required to pay taxes on money received for the benefit of someone else. Any tax consequences affect the beneficiary. Under the constructive receipt doctrine, receipt by an agent is considered receipt by the principal, here the beneficiary (see *Kamm's Estate*, 349 F.2d 953 (3d Cir. 1965), and *Maryland Casualty Co.*, 251 U.S. 342 (1920)). If the creator of the campaign can establish an agency relationship, the funds will be taxable to the beneficiary upon receipt by the agent, and the agent has no tax liability. Following the established protocol within the GoFundMe crowdfunding platform should adequately establish this relationship, but other crowdfunding sites may not have similar protocols.

On the GoFundMe platform, when agents set up the campaign account, they also have an opportunity to designate whether they are setting up the campaign for "myself" or "someone else" (support.gofundme.com (https://support.gofundme.com/hc/en-us/articles/204993267-How-do-I-create-a-campaign-on-behalf-of-someone-else-)). After designating "someone else," the agent enters the beneficiary's name and email address. They also send an email invitation to the beneficiary to set up an account. Once the beneficiary accepts the invitation, he or she becomes the only person who can withdraw donations.

Gift theory

The nature of donation-based crowdfunding is such that most of the campaign receipts will qualify as gifts on the part of the beneficiary. Under Sec. 102, gifts are not included in taxable income. If the beneficiary and/or the agent can establish that the amount received is a gift to the beneficiary, no tax is due. Unfortunately, the burden of proof will likely fall on the taxpayer, so being prepared is the best approach. As mentioned above, a gift may be distinguished from taxable income by the *Duberstein* criteria of "detached and disinterested generosity," etc. Other scenarios that may indicate a payment is not a gift include cases when a donor received consideration for a donation and when a payment represents compensation for services.

HOW TO PREPARE FOR THE IRS's ARRIVAL

Crowdfunding is still a relatively new phenomenon, and many of the individuals who raise money this way simply do not think of the tax consequences until faced with a significant tax bill or a scary letter from the IRS. We advise taking the following steps to help ensure taxpayers and their advisers can adequately address an IRS notice of deficiency or other inquiry at the appropriate time:

- Be sure to clearly identify the beneficiary of the funds on the campaign website.
- If the campaign is set up by someone other than the beneficiary, be sure to clearly indicate that the campaign creator is acting on behalf of the beneficiary.
- Be sure the campaign website clearly states that *donations* are solicited. This could include use of the word "donation" or "gift" to describe what is being requested. If possible and appropriate, the website should also state that donors will receive nothing in return for their donations.
- Print and keep a copy of the campaign website to show to the IRS. By the time the IRS issues a notice of deficiency, the campaign website may no longer be available and the taxpayer (whether an agent or a beneficiary) has no way of showing the IRS the information used to solicit donations.
- If a family member or friend set up the campaign website, received the funds, and transferred those funds to the beneficiary, keep documentation of all monetary transfers. This would support the argument that the recipient of the funds was acting as an agent for the beneficiary. Ideally, all funds should be directly withdrawn by the beneficiary of the campaign.
- The beneficiary should keep documentation to show that the funds were spent as indicated on the campaign website.

FORESIGHT AND PLANNING ARE KEY

While we can offer no guarantees, as the IRS has offered no clear guidance, we do believe that foresight and planning are the keys to successfully responding to the IRS regarding donation-based crowdfunding. If a campaign is set up correctly and documented effectively, there should be few problems.

About the authors

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