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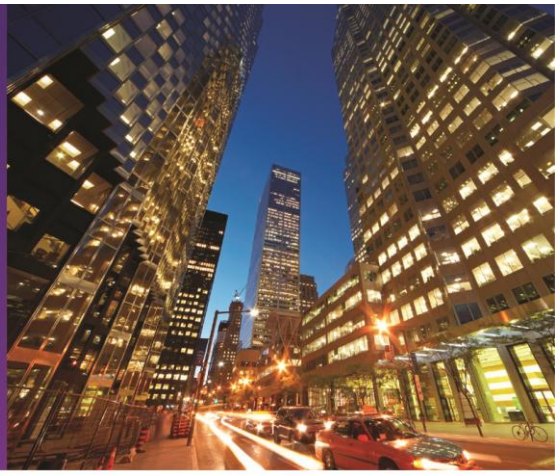

CORPORATE TAX CENTRE NEWSLETTER SERIES

EDITORIAL

SUNITA D. DOOBAY, TAXCHAMBERS LLP

Crowdfunding is on everyone's mind these days and for good reason. Kickstarter, one of the fastest growing crowdfunding platforms, recently surpassed $1 billion in pledges since its inception four years ago, half of that within the past 12 months. In 2009, Kickstarter and Indiegogo were one of the first crowdfunding platforms on the internet. Today there are more than 600 crowfunding platforms in the United States alone.

The concept of raising funds from the public is not new. For example, Joseph Pulitzer was able to raise more than $100,000 for the pedestal of the Statue of Liberty after the American Committee for the Statue of Liberty ran out of funds by appealing to readers of his newspaper. His appeal was answered by more than 125,000 individuals who contributed more than $100,000 to complete the pedestal. However raising funds through the internet, commonly referred to as "crowdfunding", is a relatively new phenomenon. The term "crowdfunding" is said to be coined in 2006 by Michael Sullivan on his blog and internet site fundavlog which was dedicated to the creation of an incubator for video related projects and contained funding functionality. On the blog Michael stated: "Many things are important factors, but funding from the 'crowd' is the base of which all else depends on and is built on. So, Crowdfunding is an accurate term to help me explain this core element of fundavlog."

There at least five different models of crowdfunding and a good summary is provided in the OSC Staff Consultation Paper 45-710 and reproduced here:

- Donation model: The practice of the crowd donating to a project or venture in exchange for noting of tangible value;
- Reward model: The practice of the crowed donating to a project or venture in exchange for some tangible reward or a "perk";
- Pre-purchase model: The purchase of the crowd donating to a project or venture in exchange for a future tangible reward (such as a consumer product);
- Peer-to-peer lending model: The practice of an online intermediary facilitating money lending between individuals to fund a business, usually in the form of unsecured business loans;
- Equity securities model: The practice of crowd investing in an issuer in exchange for securities.

THIS ISSUE

With the growing success of Kickstarter and others platforms, the popularity of the crowdfunding donation model cannot be denied. However, more recently, interest has been rapidly growing in other crowdfunding models, more specifically, equity-based crowdfunding. The recent U.S. The Jumpstart Our Business Startups Act (also known as the JOBS Act) opens the door for equity crowdfunding in the United States. Similarly in Canada there has been much excitement on the June 17, 2013 announcement of the Ontario Securities Commission approving the MaRS Social Venture Connexion (SVX) allowing the first crowdfunding platform in Canada. SVX's objective is to attract funding from accredited investors looking to invest in projects addressing social and environmental challenges in Ontario. Accredited investors wishing to invest will be required to provide identification and sign an acknowledgement of the acceptance of the investment risks. An accredited investor qualifying as a "permitted client" will not be subject to a limitation cap that they can invest on the MaRS VX. Other

accredited investors will be limited to investing a maximum of $25,000 in a single offering and a total maximum of $50,000 in a calendar year.

Ontario is not the only province making strides in equity-based crowdfunding. On December 6, 2013, Saskatchewan's securities regulator, the Financial and Consumer Affairs Authority (FCAA), announced that it would allow equity crowdfunding in Saskatchewan through the Saskatchewan Equity Crowdfunding Exemption, whereby:

- both the business and the investor must be located in Saskatchewan;
- businesses can make two, six-month offerings of $150,000 each over the course of a year;
- no person may invest more than $1,500 in an offering;
- the business cannot be a reporting issuer or an investment fund and cannot offer derivative type securities;
- businesses must give FCAA notice of their intention to issue an offering 10 business days before posting online;
- the business cannot charge investors a commission or other amounts; and
- the business must report their sales to FCAA within 30 days of the offering's close.

Canada and the United States are very much in the infancy stage in equity crowdfunding compared to the Netherlands and Sweden. Symbid, the Dutch equity crowdfunding site has been in operation since 2011. Hendrik Van Duijn will discuss the Dutch tax consequences on crowdfunding. Dag Fredlund will also provide an overview of the Swedish crowdfunding rules. I provide an overview of the current income tax consequences to crowdfunding in Canada. The IBFD generously allowed us to reproduce Paul Carman and Jeff Van Winkle's review of the U.S. tax and regulatory aspects of crowdfunding.

DUTCH TAX TREATMENT OF EQUITY CROWDFUNDING

HENDRIK VAN DUIJN, DUIJN'S TAX SOLUTIONS

Crowdfunding is becoming increasingly popular in the Netherlands. It attracts media attention, political attention[i] and attention from businesses in the Netherlands as well as abroad. The remarkable international interest of crowdfunding platforms based in the Netherlands can be demonstrated by the Symbid Corporation's listing on the OTC Markets exchange[ii].

After defining crowdfunding, this article kicks off with an overview of the tax liabilities resting with Dutch residents or with those who opt in favour of Dutch tax liability[iii]. This is followed by a summary of tax liabilities of with non-resident tax payers as per the Dutch Personal Income Tax Act 2001. The final sections are devoted to a discussion of some pertinent value added tax and inheritance tax particulars, followed by some examples on how Dutch entities and equity instruments are used for equity crowdfunding.

Defining Crowdfunding

Although crowdfunding can happen in various different forms, it is generally defined as "a collective term for a variety of structures under which funding for projects or enterprises can be obtained from a number of corporate or individual investors, often with each investor contributing a relatively small amount, usually (and sometimes exclusively) through the auspices of the web and social media"[iv]. The absence of a crystal-clear, all-encompassing definition makes an analysis complex and ambiguous. Although the purpose of crowdfunding is clear; acquiring financing from the masses, the framework is not. What the funds are used for, the capacity of the payee and recipient and how the funds are structured/labelled allows for a notable variety of tax implications of any given crowdfunding endeavour.

The recipient of the funds can use the cash for almost anything; to buy a new house, start or expand a business or develop an art-work. The capacity and the intention of the payee can also differ per payment. An art lover might want to provide funds for an art work and would not want anything in return, if the art-lover is a gadget enthusiast as well, he might see something he would like to have and would be interested in the gadget and, as opposed to a portfolio investor, not be interested in a return on investment. In this article I will restrict myself to discussing the Dutch tax treatment of equity crowdfunding, whereby the payee is an individual portfolio investor who invests in a minor equity participation[v].

Dutch Tax Framework Individual Equity Crowdfunding Investor: Introduction

The Dutch tax legislation does not yet contain any designated stipulations on the topic of crowdfunding, nor is it likely that related tax efficiency measures will be introduced any time soon. Given the fledgling stage of crowdfunding as a phenomenon, the introduction at this early juncture of a favourable tax regime could well stop the mechanism developing and flourishing, experience having shown that favourable tax treatment more often than not is followed by tax regulation culminating in a clamp-down on misuse, so that the regulatory system ends up imposing severe constraints on the business community. With this in mind I sincerely hope for continuation of the legislator's current reserved stance where crowdfunding legislation is concerned.

Resident Tax Payers

It is permissible for any Dutch-resident natural person who is a crowdfunding participant to attribute his participating interest to his domestic business assets on condition that he carries on a business venture in the Netherlands and has sound arguments to defend the attribution. Dutch (personal) income tax is then levied on the income or earnings associated with any benefits (deemed to have been) derived from the crowdfunding participation including any earnings realised from the divestment of said participation.[vi]

There are some exceptional cases in which income may be liable for tax by way of result from other activities, where there is a correlation between the actual income from the crowdfunding participation on the one hand and the participant's (or affiliate's) de facto activities or special know-how on the other.[vii]

In general, the result from a crowdfunding participation will be treated as income from portfolio investments, and will as such be taxed at a rate of 30%, where the participation in question is not otherwise subject to Dutch taxation. The taxation of portfolio investments entails a notional income being factored into the equation in the amount of 4% of the value of the underlying portfolio investments as at the start of the tax year in question.

The actual benefit from a crowdfunding participation including any profit realised when the participation was divested is not as such liable to Dutch personal income tax. Owing to the notional income method – in which no allowances whatsoever are made for the actual income – the income tax charged in this manner ends up closely resembling a 1.2% wealth tax charge.

An aspect worthy of mention is that the Dutch dividend withholding tax being withheld, by virtue of the Dutch Dividend Withholding Tax Act 1965, for the benefit of a domestic investor cum natural person, it is regarded as a pré tax charge[viii]. Whereby the domestic investor is entitled to off-set the Dutch dividend withholding tax with its Dutch personal income tax. In case the Dutch personal income tax liability is not high enough to enable set-off of the Dutch dividend withholding tax a refund in the amount of the excess is provided.

Non Resident Tax Payers

Based on the Dutch Personal Income Tax Act 2001, tax is levied on selected sources of income. The main criterion in determining whether or not a foreign tax payer is to be held liable for Dutch personal income

tax is how closely the relevant tax payer's source of income is affiliated with the Netherlands. It is for this reason that the Dutch Personal Income Tax Act 2001 provides for an exhaustive list of sources the scope of which is subject to greater limitation than that applying to domestic tax payers.

Any non-Dutch-resident natural person who is a crowdfunding participant (or holder) is not liable for any Dutch taxes on income or earnings associated with any benefits (deemed to have been) derived from the crowdfunding participation (or holding) in question, including any earnings realised from the divestment thereof, unless:

- earnings from operations accrue to the crowdfunding participant in question – be it directly or by virtue of the participant's shared entitlement to the business venture in question – relating to a business whose administrative management is Dutch-based or whose de facto operations are wholly or partially Dutch-based while the crowdfunding participation is attributable to the relevant business;
- the crowdfunding participant in question derives, or is deemed to derive, benefits by way of profit from other activities domestically, with the proviso that the liability for Dutch taxation of the profit in question is strictly contingent upon the activities in question being (deemed to be) performed within the Netherlands; or
- the crowdfunding participation in question is directly or indirectly associated with Dutch-based immoveable property.

It is important for any foreign equity crowdfunding investor cum natural person to appreciate that any Dutch dividend withholding tax having been withheld on his behalf may qualify for a reduction by virtue of the applicable double taxation treaties. Where this option turns out not to be available, the dividend withholding tax having been withheld will apply as a final tax levy for which no dividend withholding tax refund will be available unless use is made of European law. Reference is made in this context to a recent ruling by Niilo Jääskinen, one of the advocates general of the Court of Justice of the European Communities, on the topic of dividend withholding tax due and payable in connection with payments having been made to the (then) Netherlands Antilles.[ix]

With the Dutch Dividend Withholding Tax levy in mind, debt-based, asset-grouped or licensing crowdfunding, offers an attractive alternative to equity crowdfunding owing to the fact that the Dutch tax regime does not provide for interest or royalty withholding taxes being levied whereas interest and royalty charges are generally deductible from the taxable profit of a business venture that is being carried on domestically.

Value Added Tax

According to the Netherlands Turnover Tax Act 1968, the conveyance of a particular item of property involves the transfer or transition to the transferee of the powers to dispose of the item in question as if said transferee were the actual owner.[x] Any scenario involving an investor taking delivery of a product will involve liability for turnover tax. This prompts the question as to the value of the acquisition, as it is not clear what consideration has been paid in exchange. Should the price having been paid for the equity crowdfunding performance be taken as the value? This would appear to be a non-representative value where the transaction has involved partial provision of equity. The sales value, purchase value or cost may serve as a tax levying yardstick. This leaves the question as to what "cost" should be taken into consideration. The Hague District Court in a recent ruling[xi] decided that disguised dividends too may be regarded as remuneration where the levying of value added tax is concerned. It is my expectation that court proceedings and/or published policy will help clarify this matter in the not-too-distant future.

Gift Tax Aspects

In the Dutch Inheritance Tax Act 1956 it is laid down that gift tax is levied on the value of anything having been received from anyone who was a Dutch resident at the time the gift was made.[xii] Any transaction involving a Dutch resident gifting a payment to a crowdfunding platform will be liable for tax. Then again the recipient of a crowdfunding participation more often than not will not be regarded as having received a gift as defined in the Dutch Inheritance Tax Act 1956[xiii], as the payment would typically not be for not.

Examples of Equity Crowdfunding in the Netherlands

Depositary Receipts for Shares

The most commonplace equity crowdfunding method in the Netherlands is that involving the sale of depositary receipts in the capital of a Dutch-based public or private limited-liability company. The creation of depositary receipts for shares enables the separation of beneficial and legal ownership of the underlying shares. Profit payments by Dutch-based public or private limited-liability companies are liable for Dutch dividend withholding wax at a rate of 15% (or less where a double taxation convention permits). The Dutch Corporate Income Tax Act 1969 imposes corporation tax liability on the profit realised by the public or private limited-liability company, at a rate of 20% for taxable amounts of up to EUR 200,000 and 25% for any excess profit.[xiv]

An alternative option is that of issuing depositary receipts for profit-sharing rights rather than shares and selling these by way of equity crowdfunding participation. Profit pay-out on profit-sharing certificates too is liable to Dutch dividend withholding tax.[xv]

Membership of Cooperative

A Dutch cooperative qualifies as an independent bearer of rights and obligations cum legal entity, and has regular liability for Dutch corporate income tax. A Dutch cooperative has the option to deduct the members cum natural persons profit distributions[xvi] as extension profits. With the option to deduct profit distributions, the Dutch Cooperative has a particular advantage as a crowdfunding platform.

The right of membership of a Dutch-based cooperative is liable for Dutch dividend withholding tax only where the capital of the cooperative has been divided into shares[xvii] or in case of perceived abuse[xviii]. The cooperative represents a customary business format enabling entrepreneurs to cooperate in a restricted (or not so restricted) circle.

Closed End Common Fund

Rather than having corporate personality in its own right, a closed-end common (or mutual) fund (Fonds voor Gemene Rekening) represents a contract between the custodian (as the legal title holder of a particular possession) and the investors.

Closed-end common funds are transparent in terms of Dutch corporate income tax and dividend withholding taxation. The closed-end aspect (fiscal transparency) is achieved by controlling the negotiability of the participations in the fund, in that only the fund itself is at liberty to trade said participations. (The not restricted negotiability of the participations would define the fund as an open-end common fund, which as such would be liable for Dutch corporate income tax and dividend withholding tax). To date several countries, besides the Netherlands, have confirmed that they too regard the closed-end common fund as having fiscal transparency.[xix]

As a closed-end common fund is not liable for Dutch corporate income tax or dividend withholding tax, it follows that the profit attributed to a particular possession may be paid out without any tax being levied. It should be noted, however, that earnings may (be deemed to) accrue to the non-resident tax payer from a business venture whose administrative management is Dutch-based or whose de facto operations are wholly or partially Dutch-based in so far as there are Dutch-based business operations. This does not apply if the assets are merely pooled in the Netherlands via a closed-end common fund.

Issue of Depositary Receipts

The option is available in the Netherlands of separating the legal from the beneficial ownership of particular underlying assets by issuing depositary receipts. These receipts may be given unrestricted negotiability. The issue of depositary receipts for a business' assets enables funds being raised without the need to put up equity or take out a loan. As long as depositary receipts are issued for nothing other than assets and said receipts end up with a natural person who is a non-resident tax payer, the holder will not be liable for any Dutch income or gains-related tax associated with any benefit (deemed to have) derived from the relevant crowdfunding participation.

In Summary

Dutch tax legislation offers a broad range of opportunities for high-efficiency facilitation of crowdfunding projects and platforms. Given the fledgling state of crowdfunding as a phenomenon, there is every possibility that the multitude of creative ideas which are currently forming will prompt considerably different tax implications.

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TAX CONSEQUENCES TO CROWDFUNDING IN CANADA

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In Canada Revenue Agency ("CRA")'s technical interpretation document 2013-0484941E5, the CRA opined that funds received through a donation/reward crowdfunding activity would be business income to the solicitors of the funds where the funds were being solicited for a business activity and the contributor received an incentive gift such as a copy of the finished product or a promotional item such as a t-shirt. A business is broadly defined in subsection 248(1) of the Income Tax Act to include a profession, calling, trade, manufacture or undertaking of any kind whatever and, except for certain purposes, an adventure or concern in the nature of trade.

In the interpretation CRA indicated that the expenses incurred to provide donor gifts and fees paid to undertake crowdfunding activities may be deductible pursuant to paragraph 18(1)(a) of the Income Tax Act as expenses incurred with the carrying on of a business.

It is clear that the CRA treats the promotional item as consideration and refers to its Interpretation Bulletin IT-334R2 Miscellaneous Receipts as support for its position. IT-334R2 provides that "voluntary payments (or other transfers or benefits) received by virtue of a profession or by virtue of carrying on a business are taxable receipts". The following example is provided in section 4 of IT-334R2:

> For example, where a lawyer was retained to perform certain services for the class "A" shareholders of a corporation and the class "B" shareholders considered that the lawyer's work had benefited them also, any payment made by the class "B" shareholders to the lawyer would be taxable income. This is so despite the fact that there was no contract or obligation between the class "B" shareholders and the lawyer concerning this payment".

But what about a film producer who solicits funds to finish his movie but does not provide a contributor with any promotional items. Technical Interpretation 2013-0509101E5 indicates that funds collected by the film producer would be treated by CRA as taxable income because the producer made an organized effort to receive funds. The CRA cites Interpretation Bulletin IT-334R2 Miscellaneous Receipts where the following factors indicate a windfall (non-taxable receipt):

a. the taxpayer had no enforceable claim to the payment;
b. the taxpayer made no organized effort to receive the payment;
c. the taxpayer neither sought after nor solicited the payment;
d. the taxpayer had no customary or specific expectation to receive the payment;
e. the taxpayer had no reason to expect the payment would recur;
f. the payment was from a source that is not a customary source of income for the taxpayer;
g. the payment was not in consideration for or in recognition of property, services or anything else provided or to be provided by the taxpayer; and
h. the payment was not earned by the taxpayer as a result of any activity or pursuit of gain carried on by the taxpayer and was not earned in any other manner.

It is likely that the CRA will argue that the funds received by the film producer constitute business income and therefore taxable in the producer's hands because he made an organized effort to receive the payment. Of course this is all speculation because there has been no ruling on crowdfunding and the CRA has been vague and maybe wilfully so in the two technical interpretations released so far.

THE LEGAL FRAMEWORK FOR EQUITY CROWDFUNDING IN SWEDEN

DAG FREDLUND, SETTERWALLS

The past few years have seen the introduction of a new method for the financing of small and medium-sized companies through the sale of equity securities over the internet to many investors for a limited consideration. This method is often referred to as "equity crowdfunding". Equity crowdfunding also involves a “crowdfunding platform” provided by an internet funding portal in addition to issuers and investors. This article examines the legal framework for equity crowdfunding in Sweden from the issuer's perspective.

Sweden has not issued any legislation specifically addressing equity crowdfunding. However, equity crowdfunding involving the sale of securities to Swedish investors is subject to Swedish legislation in general, including Swedish securities law (primarily the *Swedish Act on Trading in Financial Instruments*[xx]) and Swedish marketing and consumer law (primarily the *Swedish Marketing Act*[xxi]). To the extent the issuer is a Swedish company, the *Swedish Companies Act*[xxii] also applies. As crowdfunding normally takes place over the internet, a number of Swedish acts will become applicable, e.g. the *Swedish E-commerce Act*[xxiii] and the Swedish Distance and Off-premises Sales Act [xxiv] which, *inter alia*, call for certain information requirements.

Under the *Act on Trading in Financial Instruments*, the issuance of securities to the public is exempted from the general obligation to prepare and register a prospectus with the Swedish Financial Supervisory Authority[xxv] if the total consideration from investors within the European Economic Area (the European Union countries, Iceland, Norway and Liechtenstein) during any twelve month period is less than €2,500,000.00. As equity crowdfunding typically falls below said threshold, the often burdensome and costly process to prepare a prospectus can often be avoided in equity crowdfunding.

To the extent the issuance of securities are directed to Swedish consumers, the *Swedish Marketing Act* applies, which, *inter alia*, provides that marketing shall comply with “good marketing practices”.[xxvi]

It should be noted that the above provisions apply to Swedish and foreign issuers alike, provided that the relevant issue is directed to Swedish investors. Hence, a Canadian issuer targeting Swedish investors can use the €2,500,000.00 exemption to avoid having to prepare and register a prospectus.

Swedish law differentiates between public companies and private companies. Private companies, under the *Swedish Companies Act*, are prohibited from advertising with the sole purpose of placing securities of the company. It should be noted that a number of Swedish private companies at present are involved in equity crowdfunding which could potentially be in breach of said prohibition.

From a Swedish tax perspective, consideration received by the issuer does not constitute taxable income.

UNITED STATES CROWDFUNDING: US TAX AND REGULATORY ISSUES

PAUL CARMAN AND JEFF VAN WINKLE

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1. Introduction

Crowdfunding or cloud funding has become increasingly popular in the United States as an alternative source of funding for small businesses, charitable organizations and even personal expenses. As is often the case in new business innovations, tax and regulatory treatment of crowdfunding has not developed as rapidly as the use of crowdfunding itself. Additionally, the regulatory framework has also lagged behind regulatory changes implemented in many foreign jurisdictions. The United States tends to apply traditional analytic tools to innovative developments, which sometimes creates confusion and surprises for participants in the process. The issues become increasingly complex from a tax perspective if either the recipients or the funding parties are non-US persons and the other parties are US persons.

One reason that traditional tax and regulatory schemes may create confusion when applied to crowdfunding is because of the variety of approaches that crowdfunding may take. All of crowdfunding has one element in common: someone wants money. But the similarity may break down after that first common issue - other than that the appeal is being made to a large group of individuals through a website or the Internet.

A significant factor in beginning the analysis of how crowdfunding should be treated is whether the funding parties are getting anything in exchange - other than a general sense of well being. If the funding sources are getting something in exchange, what is the nature of the benefit that the funding sources are receiving? Is the recipient promising to pay the money back? Is the recipient promising to give the funding sources a share in the profits of the business? Is the recipient giving the funding sources tangible or intangible personal property?

2. Tax Issues

2.1. Classification of the transaction

In order to determine the US tax consequences of a crowdfunding transaction, one must first force the transaction into one of several established buckets for which US tax rules have been developed. If the funding sources receive nothing back from the recipient other than a general sense of well being, the transaction may be treated as a gift or a charitable donation. If the recipient has promised to pay money back to the funding sources - either in full or based upon the profits of the business, the transaction may be a loan, the purchase of a stock in a corporation, a partnership interest or other financial instrument. If the funding source is receiving tangible or intangible personal property, the transaction may be a sale or a part-sale part-gift.

If the funding sources receive nothing back from the recipient, the transaction may be a gift or a charitable contribution. Requests for funding for personal issues, such as medical expenses or money to study abroad, would often be classified as gifts if nothing is given in return. When charitable organizations raise money through crowdfunding, a charitable donation may result. However, some transactions would fall in between. If a European rock band turns to crowdfunding to fund a US tour, the funding sources are paying the band to take a particular action - touring the United States.

For US federal income tax purposes, a gift must be made out of detached and disinterested generosity.[xxvii] Historically, the IRS has taken the position that any type of activity required by the recipient as a condition of the payment precludes the payment from being a gift.[xxviii] Special rules were developed to apply to scholarships and educational grants, and the special rules were eventually included in the Internal Revenue Code.[xxix] Section 117(a) excludes from gross income "any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in section 170(b)(l)(A)(ii)". The term "qualified scholarship" refers to "any amount received by an individual as a scholarship or fellowship grant to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses".[xxx]

The exclusion for scholarships would not apply to the example of crowdfunding for a band tour, however. In other words, the band, if the crowdfunding were successful, would be undertaking services required as a condition of the payment. Such a relationship is more likely to be characterized as compensation.

If the recipient of the crowdfunding is a recognized US charitable organization, a US federal, state or local governmental entity, or certain other specified organizations, the funding sources may be entitled to treat the payment as a charitable contribution. Certain non-US organizations may also qualify to receive charitable contributions for US tax purposes if a treaty with the organization's country of organization explicitly provides for reciprocal deductibility of contributions to charitable organizations. At the present time, the US tax treaties with Canada. Mexico and Israel contain such provisions. To qualify for a charitable contribution deduction, contributions must also be unrequited - that is, made with "no expectation of a financial return commensurate with the amount of the gift".[xxxi] The IRS and the courts look to the objective features of the transaction, not the subjective motives of the donor, to determine whether a gift was intended or whether a commensurate return could be expected as part of a quid pro quo exchange.[xxxii]

If the recipient promises to pay something back to the funding sources, a further analysis needs to be undertaken to determine what is the nature of the economic relationship. If the recipient promises to pay back a sum certain with a reasonable rate of interest in a reasonable period of time, the relationship may be classified as a debt.[xxxiii] If the recipient is an entity and the promise to make a repayment is contingent on the future earnings of the entity, the promise may be characterized as an equity interest in the recipient for US tax purposes. If the promise to repay is contingent upon the future earnings of a particular activity (and not all of the activities of the recipient), the promise may be characterized as a partnership formed to undertake that particular activity.[xxxiv]

In order to be characterized as debt, a variety of factors would need to be taken into consideration. Section 385(b) sets forth some of the

factors that should be taken into account to determine whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. These factors include the following: (i) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest, (ii) whether there is subordination to or preference over any indebtedness of the corporation, (iii) the ratio of debt to equity of the corporation, (iv) whether there is convertibility into the stock of the corporation and (v) the relationship between holdings of stock in the corporation and holdings of the interest in question.

The IRS has given further nuance to the statutory tests Notice 94-47.[xxxv] Notice 94-47 provides that the characterization of an instrument for US federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances. Among the factors that may be considered in making such a determination are: (i) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future, (ii) whether holders possess the right to enforce the payment of principal and interest, (iii) whether the rights of the holders of the instrument are subordinate to rights of general creditors. (iv) whether the instruments give the holders the right to participate in the management of the issuer. (v) whether the issuer is thinly capitalized. (vi) whether there is identity between holders of the instruments and stockholders of the issuer, (vii) the label placed upon the instrument by the parties. (viii) whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency or financial accounting purposes and (ix) the realistic expectation of repayment.[xxxvi] The weight given to any factor depends upon all the facts and circumstances. No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity.[xxxvii]

If the recipient promises a share in the profits of the business, a separate factual inquiry will be performed to determine whether the recipient has created a partnership with the funding sources. Under US Treasury Regulations, a business entity may be formed if the participants carry on a trade, business financial operation or venture and divide the profits therefrom.[xxxviii] The US Supreme Court has indicated that whether a partnership should be treated as real depends upon "whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both".[xxxix] It is questionable whether the parties actually intend to create a partnership in a crowdfunding situation, but all the facts and circumstances are taken into consideration in determining whether a partnership exists. So the objective facts may demonstrate the existence of a partnership even if subjectively the parties never considered the issue.

If the recipient promises a share in the profits of the business but it is not a partnership, one must be a bit imaginative to figure out what exactly the relationship is. If the source of the return is an objective index, the contract could be a notional principal contract for US federal income tax purposes.[xl] If the contract is not an objective index or neither party makes more than one payment under the agreement, the contract may be a cash-settled forward contract.[xli]

If the recipient gives the funding sources property in exchange for the money, the transaction is likely to be treated as a sale or exchange.

2.2. US federal tax treatment

If the transaction is characterized as a gift, the receipt of the cash is not included in the income of the recipient.[xlii] Unfortunately, the trade-off for this favourable treatment for the recipient is that that transaction may be subject to gift tax to the funding sources if the funding sources are individuals who are citizens or resident in the United States.[xliii] An annual exclusion and a unified credit may prevent the gift from actually being subject to tax.[xliv] The annual exclusion is USD 14,000 for 2013.[xlv] The unified credit, available to citizen and resident donors, is currently USD 5 million.

If the recipient is a recognized charitable, educational or religious organization, the amount donated may be deductible both for US federal income tax purposes and gift tax purposes.[xlvi] If the transaction is characterized as debt for US federal income tax purposes, a portion of the payment in return will be characterized as principal and a portion as interest. The interest will be US-source income subject to normal withholding rules and exceptions. Thus, a 30% withholding tax rate would be the general rule, but if the transaction qualifies for the US portfolio interest rules, no withholding would apply.[xlvii]

If the transaction is treated as the issuance of a stock interest, distributions to the funding sources will be subject to 30% withholding tax, reduced by any applicable treaty to the extent that the distribution is out of the earnings and profits of the enterprise.[xlviii] If the transaction is characterized as a partnership, the funding sources will have the same character and source of income as the recipient from the enterprise without regard to whether the funds are distributed. Partners in a partnership with income effectively connected to a US trade or business will also be required to file a US tax return and will be subject to a 35% or 39.6% withholding tax on their net effectively connected income.[xlix]

If the transaction is characterized as a notional principal contract or a forward contract, the transaction may escape US withholding regimes unless the referenced property is US stock or an index based upon US stock.

If the recipient gives the funding sources property in exchange for the contribution, the contribution will be, at least in part, a sale. Unless an exception applies, the recipient of the funding will have gain recognition to the extent that the fair market value of the property given to the funding source exceeds its tax basis.[l]

2.3. State tax issues

One side effect of the transaction being treated as a sale is that the recipient is likely to be treated as a retailer for state sales and use tax purposes unless only a very few items are sold. This would require the recipient to register as a retailer and collect sales and use tax from the funding sources in respect of each state with which the recipient has nexus.

3. US Regulatory Issues

While the tax challenge for crowdfunding is to properly characterize the transaction as one of the established buckets under US tax rules, the regulatory challenge of securities laws for crowdfunding is to categorize the kind of offering or transaction. Initially, it is important to establish common terminology regarding crowdfunding activity. Crowdfunding traditionally has meant the practice of funding a project or venture by raising many small amounts of money from a large number of people, typically via the Internet.[li] As discussed above, this can be an exchange, a transfer or a gift In the United States, crowdfunding through one of the established crowdfunding sites, such as Kickstarter, is the sale of the future right to some item or product or service in exchange for the current receipt of funds from the individual. Sometimes these transactions are called "pre-sales". Another category of crowdfunding,

which can be called "charitable crowdfunding", involves the promotion of opportunities to donate to an organization or an individual to enable that organization or individual to accomplish a specific objective. Examples include participation in Make-a-wish-type programmes. A third category of crowdfunding, which can be called "equity crowdfunding," can be described as the issuance of ownership or profit interests in a business in exchange for the contribution of cash by the individual into the business.

Currently, traditional crowdfunding and charitable crowdfunding are not regulated as securities under either the Securities Act of 1933 or the Exchange Act of 1934, the primary federal securities laws.[lii] This is because the transactions contemplated by those activities do not constitute the issuance of securities. The definition of "securities" under some state laws would potentially classify some traditional crowdfunding as the issuance of securities. This classification could mean that traditional crowdfunding violates the laws of those states.[liii] Equity crowdfunding, on the other hand, constitutes the issuance of a "security" for purposes of federal securities laws, primarily the Securities Act of 1932, and does not currently fit within any exemption from registration. However, under the JOBS Act, proposed rules were issued on 23 November 2013. In order to appropriately understand the regulatory framework impacting each of these types of crowdfunding, the discussion below will consider how each type of crowdfunding is either subject to or not covered by the Securities Act.

3.1. Traditional crowdfunding and charitable crowdfunding

Although traditional crowdfunding and charitable crowdfunding are not considered securities, that does not mean that those activities are completely exempt from regulatory oversight. A business registering on one of the crowdfunding websites in order to pre-sell an innovative product and fund the development cost for the product, may be subject to other federal or state laws. The most common laws applicable to traditional or charitable crowdfunding are consumer protection laws, the Uniform Commercial Code applicable in any jurisdiction and other sales-related laws. A company registered on a crowdfunding site that fails to deliver promised goods may be liable for damages as a result of "an unfair or deceptive act or practice".[liv] Additionally, depending upon the nature of the product, the promoter or seller of the product may also be subject to certain advertising restrictions issued by the Federal Trade Commission or by one or more state agencies.[lv]

3.2. Equity crowdfunding

Equity crowdfunding, in the form authorized under Title III of the JOBS Act, is the latest change to federal securities laws lurking immediately over the horizon. Currently, equity crowdfunding violates the Securities Act because it requires the issuance of securities without an applicable exemption from registration. On 23 September 2013, the Securities and Exchange Commission (SEC) issued the long-awaited draft rules to govern equity crowdfunding. The JOBS Act directed the SEC to issue these rules to enable companies to conduct equity crowdfunding.[lvi] Although the enabling, and in fact, directive legislation has existed since April 2012, the authority to conduct equity crowdfunding will not exist until the SEC finalizes and issues the applicable rules. Although comments are permitted on the draft rules until 3 February 2014, it is possible that the SEC will either reopen the comment period or reissue for comments after consideration of the comments that had been submitted. If the process for the earlier action under the JOBS Act for the elimination of the ban on general solicitation is all instructive in this matter, it is likely that it will take a number of months after the public comment period expires before any final crowdfunding rules are issued. Consequently, in the United States, it remains unlawful to conduct equity crowdfunding.

The proposed Title 111 rules,[lvii] which would establish a lawful framework for equity crowdfunding in the United States, demonstrate that the SEC intends to demand much of any issuer intending to use the SEC-approved crowdfunding model. The proposed rules would govern offerings under section 4(a)(6) of the JOBS Act. Section 4(a)(6) limits the amount permitted to be sold by an issuer through crowdfunding to USD 1 million in the prior 12 months. The rules clarify the maximum amount that any single investor may purchase through crowdfunding from an issuer, which ranges from USD 2,000 to USD 100,000, depending upon the financial condition of the investor.

Section 4(a)(6)(C) requires crowdfunding offerings to be conducted through a licensed broker or funding portal. The proposal includes two requirements intended to ensure that crowdfunding offerings permit public access to information regarding the offering. Portals will be required to share issuer information with interested parties. The proposed rule requires that each offering be conducted using only the intermediary and that all offerings be conducted over the Internet.

Section 4A(b)(l) of the Securities Act requires issuers relying on the section 4(a)(6) exemption to file required information with the SEC, and to provide it to investors, potential investors and the crowdfunding intermediary for the offering. Section 4A(b)(l)(l) of the Securities Act grants the SEC authority to require additional disclosure. Under the proposal, crowdfunding issuers would need to disclose information on:

- the name, address, entity form and website address of the issuer;
- the issuer's directors and officers, including their history with the company, business experience for the past three years and other information;
- the names of 20% or greater beneficial equity holders of the issuer;
- the issuer's business and business plan, likely in a form specified in the future;
- the anticipated use of proceeds;
- the target offering amount and deadline to reach it, plus additional information about the status of contribution commitments;
- the offering price and how it will be determined; and
- a detailed summary of the issuer's ownership and capital structure, describing the details of the rights of all of the classes of ownership interests.

Section 4A(b)(l)(D) of the Securities Act requires a description of the financial condition of the issuer. It includes a framework of financial disclosures required to be filed with the SEC, provided to investors and the intermediary, and made available for potential investors. The required financial disclosures depend on the aggregate amount that the issuer offers and sells under section 4(a)(6) in a rolling 12-month period.

An issuer would also be required to provide a narrative discussion of its financial condition, covering, among other things, its historic results of operations and liquidity and capital resources. Under the proposed rules, this information would be similar to management discussion and analysis disclosure required by Item 303 of Regulation S-K, but generally not as lengthy or detailed. However, a narrative description like this is dramatically different from information typically provided on a

crowdfunding website, and could be a burdensome task for any prospective issuer.

Each section 4(a)(6) issuer would be required to file with the SEC and post to its website an annual report within 120 days of the end of each fiscal year (using a designated Form C). This annual report would include information similar to the offering statement on Form C, including the financial statement and narrative disclosures meeting the highest standard applicable to any of the issuer's past section 4(a)(6) offerings, but excluding offering-specific information. The annual reporting requirement would continue until one of the following events occurred:

- the issuer becomes a reporting company;
- all the issuer's securities sold under section 4(a)(6) are purchased by a third party or repurchased by the issuer; or
- the issuer liquidates or dissolves its business under state law.

It is clear from the extent and complexity of the proposed crowdfunding rules that the regulatory requirements will be an impediment to easy use of equity crowdfunding in the United States. The SEC has asserted that the complexity required for compliance is necessary for the protection of potential investors and the reputation of the market.[lviii] Many securities law practitioners and securities brokers have commented that the actions of the SEC, while dampening the development of lawful equity crowdfunding in the United States, are generally necessary. However, there are other practitioners who believe that the SEC is being overly aggressive with the proposed rules.

3.3. Accredited crowdfunding

In anticipation of the elimination in the United States of the ban on general solicitation, a number of new crowdfunding options sprang up, even though some did not even require the flexibility arising from the elimination of the ban on general solicitations. One approach, which obtained a no-action letter from the SEC,[lix] proposes solicitation solely to accredited investors through a portal operated by a licensed broker/dealer. The portal in this instance effectively brokers the connection between the proposed investors and the issuer. There are at least two variations on this approach, although there is no market information yet available regarding this approach. The key compliance activities will fall on the broker/dealer operating the intermediary portal.

In the near future, it may be that the most common variation on accredited crowdfunding will arise from individual issuers soliciting investors through any one of a number of general solicitation methods, now that the ban on genera solicitation has been eliminated by the SEC for Rule 506(c) unregistered offerings. As a result of rules issued by the SEC and effective from 23 September 2013,[lx] issuers may broadly solicit for investors without a registered securities offering, so long as the issuer complies with a variety of requirements, which primarily include:

- only investors that have provided evidence upon which the issuer can reasonably conclude that the investor is an accredited investor;
- the issuer completes a revised Form D for the offering (and may be required to provide an advance filing of the Form D based upon additional proposed rules issued by the SEC); and
- discloses certain information to the SEC in informational filings.

The two most significant practical issues raised by these new rules will be new complexity in documenting the qualification of accredited investors and the post-funding information disclosures that are likely to be required.

Although soliciting investors through general solicitation does not fully satisfy the customary definition of crowdfunding, as it is not likely to be portal based, nor intentionally seeking a broad swath of smaller investors, currently it seems to be a viable alternative to crowdfunding and may often be confused with crowdfunding. Many securities practitioners also believe that this modification of the federal securities laws opens the door for new offering abuses by issuers. However, the perception of the potential opportunity of a huge, new world of investors available to issuers will likely result in many issuers attempting to use this rule to find and subscribe investors.

As a result of the creativity of the capital market in the United States and the demand for capital by smaller issuers, it is likely that each of the crowdfunding variations will be pursued, even though the regulatory compliance is generally complex and the restrictions imposed on issuers create potential liability and may impair future capital raising efforts by the issuer.

4. Conclusion

From a US tax perspective, the discussion in this article probably left the reader feeling rather uncomfortable. The discussion treats crowdfunding as if it were, well, normal. The discussion assumes that documentation is provided to support required information exchange and to qualify for reduced rates of withholding under applicable treaties.

In the United States, business practices had gotten ahead of the regulatory regimes. This initial observation assumes that the regulatory regimes must change to conform to crowdfunding. Current tax rules are flexible enough in interpretation to handle crowdfunding, but the participants may not like the results.

And unfortunately, the regulatory discussion in this article confirms that true crowdfunding activity in the United States in order to obtain a share in profits remains unlawful, even though there are a number of fundraising activities that bear close resemblance to crowdfunding. Although true crowdfunding in the United States by US-based issuers is close at hand, the regulatory scheme may deter many issuers. This means that in the near future, any issuer or investor seeking to use crowdfunding as a source or use of capital will need to proceed cautiously, confirming at each turn the tax and regulatory treatment of the activity.

[i] Reference is made to the research report on Crowdfunding and Informal Investing performed on behalf of the Dutch Ministry of Economic Affairs which draws a thoughtful landscape of Crowdfunding in the Netherlands by KplusV organisatie-advies: http://www.rijksoverheid.nl/documenten-en-publicaties/rapporten/2013/12/19/onderzoek-crowdfunding-en-informal-investing.html

[ii] Symbid will trade on a segment of the OTC Markets, OTCQB, under ticker symbol "SBID" http://money.cnn.com/news/newsfeeds/articles/marketwire/1092393.htm

[iii] *Dutch Personal Income Tax Act 2001*, Section 3.74

[iv] J. Cape & H. Dayananda, Tax and Crowdfunding: Is the United Kingdom Getting Lost in the Crowd?, 16 Derivs. & Fin. Instrums. 1 (2014), Journals IBFD.

[v] Article 4.6 *Dutch Personal Income Tax Act 2001* sets out that a direct or indirect participation of at least 5% in the nominal paid up capital, any class of shares, stock options, profit rights or 5% voting power in company with a capital divided by shares qualifies as a substantial interest. Article 4.5a *Dutch Personal Income Tax Act 2001* stipulates that a Dutch Cooperative is deemed to be a limited liability company and an interest in a Dutch Cooperative qualifies as a profit right. We assume that this substantial interest legislation does not apply to crowd fund porfolio investors as the nature of the investment is to participate with a significant group of other investors, therefore limiting the percentage of equity interest to below 5%.

[vi] A system of graduated or progressive income tax rates applies in the Netherlands ranging from 5.1% for incomes of up to EUR 19,645 to 52% for incomes in excess of EUR 56,531, Article 2.10 *Dutch Personal Income Tax Act 2001*,– 2014 rates. An Small and Medium Sized companies allowance in the amount of 14% is additionally available for income derived from a Dutch business enterprise (*Dutch Personal Income Tax Act 2001*, Section 3.74).

[vii] Same rate as under the prior footnote, except Small and Medium Sized companies allowance does not apply.

[viii] Article 5 of the *Dutch Dividend Withholding Tax Act 1965*.

[ix] http://www/duijntax.com/news/9/168/Dutch-dividend-withhlding-tax-may-violate-right-to-free-capital-movement/.

[x] Section 3(1) sub (a) of the *Dutch Turnover Tax Act 1968*.

[xi] Hague District Court ruling dated August 22nd, 2013, case number SGR 13/2376, ECLI:NL:RBDHA:2013:11083.

[xii] Article 1 sub (2) of the *Dutch Inheritance Tax Act 1956*.

[xiii] Article 1 sub (7) of the *Dutch Inheritance Tax Act 1956*, in conjunction with Section 2:186 of the *Dutch Civil Code*.

[xiv] Article 22 of the *Dutch Corporate Income Tax Act 1969*.

[xv] Article 1 of the *Dutch Dividend Withholding Tax Act 1965*.

[xvi] Article 9(1) sub (g) in conjunction with Article 9(2) of the *Dutch Corporate Income Tax Act 1969*.

[xvii] Article 1(7) of the *Dutch Dividend Withholding Tax Act 1965*.

[xviii] Article 1(1) of the *Dutch Dividend Withholding Tax Act 1965*.

[xix] To date the Netherlands has concluded common fund taxation conventions with Canada, the United Kingdom, Belgium, South Africa, Norway and several other countries.

[xx] LAG OM HANDEL MED FINANSIELLA INSTRUMENT [ACT ON TRADING IN FINANCIAL INSTRUMENT] (Svensk författningssamling [SFS] 1991:980).

[xxi] MARKNADSFÖRINGSLAGEN [MARKETING ACT] (Svensk författningssamling [SFS] 2008:846).

[xxii] AKTIEBOLAGSLAGEN [COMPANIES ACT] (Svensk författningssamling [SFS] 2005:551).

[xxiii] LAG OM ELEKTRONISK HANDEL OCH ANDRA INFORMATIONSSAMHÄLLETS TJÄNSTER [E-COMMERCE ACT] (Svensk författningssamling [SFS] 2002:562).

[xxiv] DISTAN- OCH HEMFÖRSÄLJNINGSLAGEN [DISTANCE AND OFF-PREMISSES SALES ACT] Svensk författningssamling [SFS] 2005:59.

[xxv] *See* ACT ON TRADING IN FINANCIAL INSTRUMENTS, *supra* note 1, 2 ch 4 §.

[xxvi] *See* MARKETING ACT, *supra* note 2, 5 §.

[xxvii] US: SC, *Commissioner v. Duberstein*, 363 US 278 (1960).

[xxviii] I.T. 4056, 1951-2 C.B. 8.

[xxix] The Internal Revenue Code of 1986, as amended [the Code). References to sections in this article are references to sections of the Code unless otherwise indicated.

[xxx] IRC sec. 117(b)(l).

[xxxi] US: SC, *Hernandez v. Commissioner of Internal Revenue*. 490 U.S. 680,690 (1989).

[xxxii] *Hernandez v. Commissioner of Internal Revenue*, at 690-91

[xxxiii] US: AC 2d Cir., *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957). *See generally* the discussion of the distinction of debt, equity and other financial arrangements in P. Carman & K. Bender, *Debt, Equity or Other: Applying a Binary Analysis in a Multidimensional World*, 107 J. Taxn. 17 (July 2007).

[xxxiv] *See* P. Carman & C. Kushner. *The Uncertain Certainty of Being a Partner: Partner Classification for Tax Purposes*, 109 J. Taxn. 165 (Sept. 2008).

[xxxv] 1994-1 C.B. 357.

[xxxvi] OTHER FACTORS. Other factors that may be relevant in classifying an instrument as either debt or equity for US Federal income tax purposes include the following:

(1) Convertibility of the instrument into stock of the issuer (an equity characteristic). In this case, the transaction documents do not have a conversion feature.
(2) A sinking fund (a debt characteristic). In this case, there is no sinking fund provision.
(3) Contingent payments (an equity characteristic). In this case, there are no contingent payments.
(4) Ability of the issuer to obtain loans from outside lending institutions (a debt characteristic).
(5) Failure of the debtor to repay on the due date or to seek a postponement (an equity characteristic).

See e.g. US: AC 11th Cir., *Stinnet's Pontiac Service, Inc. v Commissioner*, 730 F.2d 634, 638 (11th Cir. 1984). The intent of the parties is also considered. *See* US: TC, *Smithco Engineering, Inc. v. Commissioner*, 47 T.C.M. (CCH) 966, 969 (1984).

[xxxvii] US: SC, *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946).

[xxxviii] US Treas. Reg. sec. 301.7701-1(a)(2).

[xxxix] US: SC, *Commissioner v. Culbertson*, 337 U.S. 733.742 (1949).

[xl] US Treas. Reg. sec. 1.446-3(c)(l)(i). See FTC G-2554.
[xli] *See* Rev. Rul. 2003-5 C.B. 363. *See also* Rev. Rul. 2004-15, 2004-8 I.R.B. 515: Rev. Rul. 2003-31, 2003-1 C.B. 643.
[xlii] US IRC sec 102.
[xliii] US IRC sec. 2501. Non-resident non-citizens may be subject to US gift tax in certain circumstances.
[xliv] US IRC secs. 2503(b). 2505.
[xlv] US: Rev. Proc. 2011-52,2011-45 IRB.
[xlvi] US IRC sec 170; 2522.
[xlvii] US IRC sec. 871(h).
[xlviii] US IRC sec. 871.
[xlix] US IRC sec. 1446.
[l] US IRC sec. 1001.
[li] Definition of 'crowdfunding". 0xforddictionaries.com.
[lii] *See* comments of Lori. Schock, Director. Office of Investor Education and Advocacy. SEC, *InvestEd 2012* (9 June 2012).
[liii] *See* e.g. California Corporations Code, sec. 25019.
[liv] *See* e.g. Massachusetts General Laws, sec. 93A.
[lv] Federal Trade Commission, .Corn Disclosures (Mar. 2013).
[lvi] The Jumpstart Our Business Startups Act, Public Law 112-106 (5 Apr. 2012).
[lvii] Release Nos. 33-9470. 34-70741. File N. S7-09-13, RIN 3325-AL37.
[lviii] Release Nos. 33.9470, 34.70741, File N. S7-09-13. RIN 3325-AL37, at 12-14.
[lix] FundersClub Inc. and FundersClub Management LLC, SEC No-Action Letter, 2013 SEC No-Act. LEXIS 271 (26 Mar. 2013)
[lx] 17 CFR Parts 230. 239 and 242. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings. File No. S7-07-12. RIN 3235-AL34 (10 July 2013).

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