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Crowdfunded Entrepreneurs, Tripped Up by the Taxman

By STACY COWLEY MARCH 18, 2015

Jenny Wecker, a fledgling Salt Lake City entrepreneur, had a hit on her hands at the end of December: She collected $42,000 in pledges from the crowdfunding site Kickstarter for more than 300 orders of a stylish diaper bag she had designed.

The project came together in a whirlwind after her husband persuaded her to test a broader market for the bags, which she had been making by hand and marketing on Instagram.

"We didn't even think twice about how the taxes would affect us," she said.

But with tax preparation time in full swing, thousands of people like Ms. Wecker who ran successful crowdfunding campaigns last year no longer have the luxury of ignoring the tax consequences of their efforts. In the eyes of the Internal Revenue Service, they are small-business owners — and come April 15, the taxman wants his share of their proceeds.

Sites like Kickstarter and Indiegogo make it fairly easy for creative entrepreneurs to propose new ventures and, if the ideas appeal to a big enough audience, attract capital to finance them. But once the cash changes hands, those who may never have run a business before are thrown straight into the weeds of operating one.

The tax issues can be complex, and as the deadline approaches, terror and confusion reign.

"People come to me after they get a 1099-K, usually in a panic reaction," said Abraham Finberg, a tax accountant in Los Angeles.

The form he refers to is the one that tips the I.R.S. off to crowdfunding campaigns. Introduced three years ago, the document is intended to help tax authorities track the kind of online sales that small businesses often do not report. Companies like Amazon, PayPal and Stripe that process payments for crowdfunding sites are required to send the form to any customer for whom they register 200 annual transactions totaling at least $20,000. (Only 15 percent of the 22,252 projects financed on Kickstarter last year passed that threshold. Smaller projects are still taxable, but they create less of a paper trail for tax authorities to follow.)

Ms. Wecker's tax liability was complicated by a timing issue that ensnares many novices: She ran her campaign in December but was not able to place her overseas production order for the bags until January, which left her with a big chunk of business income in one year and the major expenses to offset it in the next.

That common crowdfunding pitfall can leave entrepreneurs struggling to pay a larger-than-expected tax bill. Accountants say there are a few ways to handle it, but each involves nuances that are best sorted through with professional help. Businesses with certain corporate structures may be able to adopt a fiscal year that aligns their income and expenses. Others might opt to use an accounting method known as "accrual," which can let those who presell items delay recognizing the income until customers receive the goods.

One of the most overlooked complications is sales tax. The rules governing it vary by location, and trying to comply with them can be a brain-bending exercise in untangling financial minutiae.

In many states, merchants have to remit the tax on anything they sell to an in-state buyer. Do digital goods like e-books count? In most states yes, but a few, like North Dakota, specifically exempt them. What about intangibles, like the Skype chats artists sometimes offer their backers? Some states tax them just like retail goods; some exclude them. In others, the rules are still being written.

Matthew Amster-Burton, a Seattle author who raised $8,000 on Kickstarter for his culinary travel memoir "Pretty Good Number One," offered a book club chat as a reward for those who pledged $125. He asked Washington State's revenue department for a ruling on whether he could classify some of that money as sales of a service, not a retail good, which would have reduced his tax burden. Its verdict:

No. He owed sales tax on everything he collected from in-state buyers, and to calculate it, he had to ask all of his project's backers for their ZIP codes — information Kickstarter does not provide — and figure out the correct rate for each Washington resident's city or county.

"I'm really annoyed at how difficult Kickstarter and my state make it to do the right thing," he said. "I think I ended up owing less than $100 in tax on my campaign, but it took at least a full week of work to figure it all out."

A Kickstarter spokesman, Justin Kazmark, said the site was trying to improve its tools for helping creators calculate the costs of fulfilling their projects, including expenses like shipping and taxes.

"We have some very basic educational materials at the moment," he said. "We're ramping that up significantly."

Because project creators have no way to know in advance how many of their backers will be local, even those who plan for sales tax are stuck trying to guesstimate how they should price it into their rewards. Most do not even try.

"If we have local backers, we just have to take the hit. You play the odds there," said Jarom Olson, the supply-chain manager for Sewell Development Corporation, a company in Orem, Utah, that has run several Kickstarter campaigns for new products in its MOS line of gadget accessories. "It's a pretty small percentage for us, but it can be painful if you didn't account for it."

Where things get really swampy are the areas that even tax experts disagree about how to handle. The big one is whether, in some circumstances, certain crowdfunding pledges can be treated as gifts, not sales.

On its website, the I.R.S. defines a gift as money a donor gives "without expecting to receive something of at least equal value in return." Most of the rewards crowdfunders offer their backers do not pass that test. For a $115 contribution to Ms. Wecker's Kickstarter, for example, backers will receive a bag that she plans to price at $130 on her website.

But many crowdfunding campaigns incorporate a handful of higher-priced rewards, aimed at fans with deep pockets.

If you pledge $250 in return for having your name painted on a food truck, could part of your pledge be considered a donation?

The I.R.S., which has not issued guidance on the subject, declined to comment.

"For tax pros, most people seem to be settling in the camp of 'better safe than sorry,'" said Kelly Phillips Erb, a Pennsylvania lawyer who focuses on tax law. But she said she thinks there's wiggle room. "This is like the next Bitcoin. At some point, the I.R.S. will have to weigh in."

Ms. Wecker, who usually does her own taxes with TurboTax, hired an accountant this year. She and her husband both have full-time jobs outside her new design business and were initially expecting a sizable refund. Instead, they came out about even — which she counts as a relief.

Since her Kickstarter campaign ended, she has received a steady stream of inquiries about her bags, and has several potential retail and wholesale clients lined up. The small bit of money she lost on the crowdfunding project was worth it to get the business off the ground, she said.

"This is part of being a beginner," she said. "You make some mistakes, and try not to make them twice."

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