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Income tax and crowdfunding: when old meets new

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1 Introduction

1.1 Background

It was a beehive, of all things, that delivered Australia onto the world crowdfunding scene. The Flow Hive just might be the holy grail for amateur beekeepers: a hive that releases honey without contact between the bees and their keeper. On the other hand, it might not work at all. But with a novel concept and an enticing story to tell, the makers of Flow Hive have pre-sold over 13,000 of their products before the first Flow Hive has even hit the market.

The proceeds? A cool USD 12,174,727.

And to think they only originally asked for USD 70,000.

Crowdfunding – the act of obtaining funding online from a wide range of people – is a global phenomenon that allows individuals and businesses to raise funds in a number of different ways for a near infinite number of purposes.

Flow Hive relied predominantly on the common and widely used "reward-based funding", in which the friendly Byron Bay locals undertook to provide goods to thousands of world-wide funders, supplemented with donations from people keen to see the Flow Hive become a reality (**donation-based funding**).

With the Government now inching ever closer to relaxing certain rules which currently restrict start-ups from issuing equity to crowdfunding investors (**equity-based funding**) and the mooted rise of peer-to-peer and peer-to-business lending platforms (**debt-based funding**), crowdfunding options in Australia may be about to increase dramatically.

Despite these advances and encouraging public statements from the Government about the potential advantages of crowdfunding, there has been little discussion of whether the income tax system – which relies heavily on concepts established through cases decided well before the advent of the internet – is sufficiently flexible to accommodate, or even encourage, the use of crowdfunding. Indeed, it may be that the Government has passed up the opportunity to close the loop on the regulatory burdens by ensuring that the income tax outcomes are reasonable and supportive of the adoption of crowdfunding by small enterprises.

This article seeks to identify and address the likely income tax implications of raising funds through the most common crowdfunding models.[1] In doing so, the article attempts to highlight complexities that can arise when looking at a very simple example of a company, StartUpCo, that is carrying on a business and seeking to raise funds to expand

[1] Although GST is not covered in this article, the potential GST implications of crowdfunding are set out in: Australian Taxation Office, 'GST and Crowdfunding' (13 November 2014).

its business and bring more goods to market (i.e. StartUpCo will carry on an income producing business).

In practice, additional important questions will be whether StartUpCo is, in fact, carrying on a business, the point in time the business commences and whether the proposed activities could constitute a new and separate business. This is because the income tax consequences may differ if crowdfunding is used for purely private purposes or as part of a hobby. The ability to claim deductions for expenditure will also depend on these and other facts, and may or may not align with the tax treatment of funding amounts received. However, in the interests of keeping this article to a manageable size, these issues are beyond the scope of this article.

Nevertheless, this article highlights sufficient complexities to suggest that, as a starting point, guidance is likely to be needed from the Government or the Australian Taxation Office (**ATO**) to ensure that tax uncertainty is not another regulatory barrier to the adoption of crowdfunding.

1.2 Crowdfunding models

The crowdfunding models available to StartUpCo can be grouped into 4 categories:

- **reward-based funding:**
  - funder receives goods or services provided by StartUpCo;
  - commonly used to raise funds in advance of the products or services entering full scale production;
  - platform examples: Kickstarter (US), IndieGoGo (US), Pozible (Australia);
- **donation-based funding:**
  - funder receives nothing in return other than acknowledgement of payment by StartUpCo;
  - payments are usually only small amount, e.g. $5, but can be higher;
  - platform examples: gofundme (US), GiveForward (US), YouCaring (US);
- **equity-based funding:**
  - funder receives equity issued by StartUpCo, which may provide the funder with voting rights and rights to dividends and capital of StartUpCo;
  - StartUpCo has the right, but not the obligation, to distribute dividends and capital to the funder;
  - currently subject to heavy restrictions in Australia but the Government is looking to relax certain requirements;
  - platform examples: Venture Crowd (Australia), AngelList (US), Early Shares (US);
- **debt-based funding:**
  - funder receives debt issued by StartUpCo, which provides the funder with a right to receive a payment of interest and a repayment of principal;
  - StartUpCo promises to repay principal and pay interest to the funder;
  - least common approach as it imposes the heaviest financial obligations on StartUpCo and is subject to strict regulatory requirements in Australia;

– platform examples: Lending Club (US), Prosper (US), Funding Circle (UK).

StartUpCo may use just one of these models or it may use a combination. For example, the most common approach for business-related funding is to allow people to make small value donations and also offer products or services for funders who contribute greater amounts (i.e. combine donation-based funding and reward-based funding).

1.3 Regulation of crowdfunding

The regulatory environment has struggled to adapt to the rise of crowdfunding, with the Australian Securities and Investments Commission (**ASIC**) issuing guidance in 2012 warning that the crowdfunding models could, depending on the circumstances:[2]

- be subject to the *Australian Consumer Law;*
- involve a managed investment scheme under Chapter 5C of the *Corporations Act 2001* (Cth);
- constitute the provision of financial services requiring an Australian financial services licence; and
- constitute a fundraising under Chapter 6D of the Corporations Act, which is not permitted by proprietary companies except in limited circumstances.

In addition, equity-based and debt-based funding could constitute an offer to issue shares or debentures, requiring StartUpCo to lodge a prospectus or other complying disclosure documents, and the issue of shares to more than 50 shareholders could result in StartUpCo becoming subject to corporate governance and financial reporting obligations as an unlisted public company.

Other jurisdictions, including the United States, United Kingdom and New Zealand, have experienced similar issues and have sought to accommodate crowdfunding by relaxing regulatory requirements that would otherwise apply or creating specific crowdfunding regimes.[3] This has been done with the express purpose of encouraging the use of crowdfunding by small enterprises and is necessarily predicated on the view that funders are aware of the high-risk nature of their contributions and therefore do not need the usual investor protections.

Australia is cautiously following suit, with the Government using the 2015 Federal Budget to commit to making it easier for companies to use equity-based crowdfunding. The commitment follows a Treasury discussion paper on the subject and subsequent public consultation, but the final scope of the proposals remains to be seen.

The process to date has spent little time considering the income tax implications of crowdfunding, with neither the Corporations and Markets Advisory Committee report nor the Treasury discussion paper on crowd sourced equity funding making any significant mention of income tax. It may be that the tax treatment of equity-based crowdfunding (as discussed below) is sufficiently certain that it does not warrant discussion. However, within the overall context of addressing regulatory impediments to the use of crowdfunding the Government could have taken the opportunity to also consider whether the omnipresent tax system is supportive of the overall policy objectives being pursued.

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[2] Australian Securities and Investments Commission, '12-196MR ASIC guidance on crowd funding' (Media release, 13 August 2012).

[3] See, for example, *Jumpstart Our Business Startups Act 2012* (US), Financial Conduct Authority Policy Statement PS 14/4 (UK), *Financial Markets Conduct Act 2013* (NZ) and *Financial Markets Conduct Regulations 2014* (NZ).

2 Reward-based funding

2.1 Overview

Reward-based funding, the most common form of crowdfunding for businesses, will oblige StartUpCo to provide goods to the funders. The exact nature of that obligation may depend on the platform used.

For example, popular US reward-based and donation-based crowdfunding platform Kickstarter provides the following terms:

> *If a creator is unable to complete their project and fulfill rewards, they've failed to live up to the basic obligations of this agreement. To right this, they must make every reasonable effort to find another way of bringing the project to the best possible conclusion for backers. A creator in this position has only remedied the situation and met their obligations to backers if:*
>
> – *they post an update that explains what work has been done, how funds were used, and what prevents them from finishing the project as planned;*
>
> – *they work diligently and in good faith to bring the project to the best possible conclusion in a timeframe that's communicated to backers;*
>
> – *they're able to demonstrate that they've used funds appropriately and made every reasonable effort to complete the project as promised;*
>
> – *they've been honest, and have made no material misrepresentations in their communication to backers; and*
>
> – *they offer to return any remaining funds to backers who have not received their reward (in proportion to the amounts pledged), or else explain how those funds will be used to complete the project in some alternate form.*
>
> *The creator is solely responsible for fulfilling the promises made in their project. If they're unable to satisfy the terms of this agreement, they may be subject to legal action by backers.*

IndieGogo, which the Flow Hive makers used to great success, adopts a more succinct approach:

> *Campaign Owners are legally bound to perform on any promise and/or commitment to Contributors (including delivering any Perks). If a Campaign Owner is unable to perform on any promise and/or commitment to Contributors, the Campaign Owner will work with the Contributors to reach a mutually satisfactory resolution, which may include the issuance of a refund of Contributions by the Campaign Owner.*

Finally, Australia's own Pozible prefers to remain a little more vague but suggests that StartUpCo will be under an obligation to deliver the goods:

> *Project creators are fully responsible for delivering the rewards set out in the project, and by the time agreed; Pozible simply provides the platform to showcase the rewards featured, and the person behind the project. If you are unable to deliver all rewards to all supporters as set out in your project, you may be in breach of consumer law and possibly responsible for providing a full refund to your project supporters.*
>
> …
>
> *All sales are binding. The seller is obligated to ship the Reward(s) or otherwise complete the transaction with the Project Supporter, unless there is an exceptional circumstance, such as: (a) the Project Supporter fails to meet the terms of the Project Creator's listing (such as payment method), or (b) the*

> *Project Creator cannot authenticate the Project Supporter's identity. The Project Supporter is obligated to deliver appropriate payment for Rewards purchased, unless there is an exceptional circumstance.*

It is therefore not entirely clear for the purpose of our case study (and beyond the scope of this article to determine) the nature of the legal obligations imposed on StartUpCo, but there is at least the possibility that it will assume some form of legal obligation.

2.2 Are the funds income?

There is little doubt that the funds received using reward-based funding will be ordinary income of StartUpCo and therefore assessable.[4]

The funds are received as consideration for the provision of goods, meaning that those goods "supply the touchstone for ascertaining whether the receipt is on revenue account or not."[5] Since the supply of the goods or services is the business of StartUpCo, the funds are received in the ordinary course of StartUpCo's business and the funds will therefore be ordinary income.

In practice, the answer may not always be as clear cut. If StartUpCo is yet to commence its business, which will depend on the facts applicable to StartUpCo when it receives the funds, the funds may not constitute business income. In such circumstances, StartUpCo would need to consider the potential application of the capital gains tax provisions and identify the grounds, if any, for claiming deductions for expenditure incurred.

2.3 Timing

Even if StartUpCo is not under a legal obligation to provide the goods it should be reasonable for StartUpCo to treat the funds as being derived only after it has reached the agreed deadline for delivering the goods.

In the case where goods are delivered, deriving the income at the time of delivery should give a "substantially correct reflex of the taxpayer's true income" as StartUpCo has done all steps necessary to earn the funds at that point in time.[6]

In the case where goods are not delivered, it should still be reasonable for StartUpCo to defer the recognition of the funds as income until it has reached its deadline for delivering the goods notwithstanding there may not be a legal obligation to deliver the goods. This is because up and until that point in time:[7]

> *…as a matter of business good sense, [StartUpCo] should treat each amount of fees received but not yet earned as subject to the contingency that the whole or some part of it may have in effect to be paid back, even if only as damages, should the agreed quid pro quo not be rendered in due course. The possibility of having to make such a payment back (we speak, of course, in practical terms) is an inherent characteristic of the receipt itself.*

To treat the funds as derived prior to this point in time "would be out of accord with the realities of the situation" that StartUpCo may have to refund some or all of the funds or provide alternative remedies.[8]

Indeed, given the "necessity for earning which is inherent in the circumstances of the receipt" it is unlikely that the funds will be derived in the case of non-delivery by

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[4] Section 6-5 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**). In this article, all references to legislative provisions are references to the ITAA 1997 unless otherwise stated.

[5] *The Federal Coke Company Pty Ltd v. F.C. of T.* (1977) 34 FLR 375 at 401-402 per Brennan J.

[6] *The Commissioner of Taxes (South Australia) v The Executor Trustee and Agency Company of South Australia Ltd* (1938) 63 CLR 108 at 154 per Dixon J.

[7] *Arthur Murray (NSW) Pty Ltd v. F.C. of T.* (1965) 114 CLR 314 at 319 per Barwick C.J., Kitto and Taylor JJ.

[8] *Arthur Murray (NSW) Pty Ltd v. F.C. of T.* (1965) 114 CLR 314 at 319 per Barwick C.J., Kitto and Taylor JJ.

StartUpCo until such time as it has reached a settlement or agreement with the funders.[9] In the event of a full refund, this should have the practical effect that StartUpCo would not recognise any net assessable income in respect of the refunded amounts.

In the event that the goods to be supplied by StartUpCo are trading stock, outgoings incurred in connection with acquiring the rewards should be deductible and the opening and closing stock on hand will be taken into account in working out the taxable income of StartUpCo.[10]

3 Donation-based funding

3.1 Overview

Under a donation-based funding model StartUpCo will not commit to provide anything of material value to the funders. Instead, it will usually merely acknowledge the contribution made by the funder, often in the form of a list of funders on its website, and use the money to assist with the development of its business.

3.2 Are the funds income?

In substance, the funds received by StartUpCo enlarge its capital, which may be akin to the issue of shares described as follows:[11]

> *Indeed the issue of shares by a trading company is not a trading transaction at all. The corporate entity becomes pro tanto larger; but the receipts of the trade on the one hand and the amount of the costs and expenditure necessary for earning those receipts on the other remain unaltered, and it is the difference between those two sums which is taxable...*

For similar reasons it would make sense if donation-based funding is considered a non-taxable expansion of capital rather than income, as the receipt of funds is not a trading transaction and does not constitute the receipts of trade. Indeed, an amount received under the donation-based model has the qualities of a gift, both in ordinary parlance and in the manner accepted by the courts for income tax purposes.[12]

However, there is a considerable line of case law that establishes a gift can, in many but certainly not all cases, be income.

While there is no clear dividing line between gifts that are income and those that are not, the courts have established the following principles: [13]

1. the whole of the circumstances must be considered;[14]
2. whether or not a particular receipt is income depends on its quality in the hands of the recipient;[15]
3. the motives of the donor are relevant but rarely, if ever, decisive;[16]
4. regularity or periodicity will be a relevant but not decisive consideration;[17]

[9] *Arthur Murray (NSW) Pty Ltd v. F.C. of T.* (1965) 114 CLR 314 at 319 per Barwick C.J., Kitto and Taylor JJ.

[10] Division 70.

[11] *Lowry (Inspector of Taxes) v. Consolidated African Selection Trust Ltd* (1940) 23 TC 259 at 284 per Viscount Maugham.

[12] See *F.C. of T. v. McPhail* (1968) 117 CLR 111 and *Leary v. F.C of T.* 80 ATC 4438.

[13] *FC of T v. Harris* (1979) 37 FLR 325.

[14] *Squatting Investment Co. Ltd. v. F.C. of T.* (1953) 86 CLR 570.

[15] *Scott v. F.C. of T.* (1966) 117 CLR 514.

[16] *Scott v. F.C. of T.* (1966) 117 CLR 514.

5 a generally decisive consideration is whether the receipt is the product in a real sense of employment of, or services rendered by the recipient, or of any business, or, indeed, any revenue producing activity carried on by the recipient.[18]

The first four factors are not considered by the courts to be decisive and, without stepping through them in detail, it is sufficient to say that the donation-based funding will generally be provided in respect of future income producing activities to be undertaken by StartUpCo and will have been actively solicited by StartUpCo, giving the funds the flavour of income.

The final and decisive consideration is whether there is a sufficient connection for it to be said that the funds are a product of the income producing activities of StartUpCo.

Where there is no legal obligation on the funder to provide the funds and no consideration is required to be provided by the recipient:[19]

> *...an enquiry into the "how and why" of the receipt may reveal the matter in respect of which the payment is received. If there be a consensus between the payer and the payee, their common understanding may identify the relevant matter.*

It should be easy to identify a common understanding between a funder and StartUpCo. A crowdfunding campaign will usually identify the broad purpose to which the funds will be put (to borrow an example from a Kickstarter campaign: "All that we need today is money to fund the production.") and the recipient will often commit to a production timeline, which includes milestones such as full production and first shipment.

The common understanding, in other words, is that the funds will be received in order to further the business of StartUpCo, indicating that the funds are a product of the income producing activities of StartUpCo.

Further:

- the receipt of the funds well in advance of the income producing activities of StartUpCo may not be sufficient to break the nexus;[20]
- although the courts recognise that subsidies to start a business can be capital in nature, this may be limited to circumstances in which the use of the funds is limited to capital expenditure (which is not usually the case under the donation-based model);[21]
- StartUpCo is a company planning to develop its business and it is hard to discern any personal qualities that are independent of StartUpCo's intention to undertake income producing activities;[22] and
- if StartUpCo sets an explicit funding target it may have an expectation of, and a economic dependence on, receiving the funding.[23]

This analysis may suggest that the funds are the product of StartUpCo's income producing activities and should be treated as income.

Much of this case law developed in an earlier era and concerns remarkably different situations, such as a gift to the family solicitor, and perhaps is not appropriate for

[17] *F.C. of T. v. Dixon* (1952) 86 CLR 540.

[18] *Hayes v. F.C. of T.* (1956) 96 C.L.R. 47; *Scott v. F.C. of T.* (1966) 117 CLR 514; *Squatting Investment Co. Ltd. v. F.C. of T.* (1953) 86 CLR 570.

[19] *The Federal Coke Company Pty Ltd v. F.C. of T.* (1977) 34 FLR 375 at 401-402 per Brennan J.

[20] *MIM Holdings Ltd v. Commissioner of Taxation* (1997) 36 ATR 108.

[21] *GP International Pipecoaters Pty Ltd v. F.C. of T.* (1990) 170 CLR 124.

[22] *Scott v. F.C. of T.* (1966) 117 CLR 514.

[23] *F.C. of T. v. Dixon* (1952) 86 CLR 540.

donation-based crowdfunding which, as set out at the start of this section, in substance arguably involves the enlargement of the capital of a business separate from any trading activities. Further, certain taxpayers may be able to demonstrate that there is not a sufficient nexus between the donation-based funding and the activities that will produce assessable income, including as a result of the funds being required in order for a business to commence, which may alter the conclusion. Nevertheless, in this example it may be difficult to escape the established principles which point towards the funds being income of StartUpCo, and hence taxable.

For completeness, the existing statutory framework does not provide much guidance on the appropriate outcome. A bounty or subsidy, which similarly increases the capital of a taxpayer, will be statutory income if it is received in relation to carrying on a business but not if it is received to commence the business. This distinction is based on an interpretation of the specific wording of the provision rather than any clearly articulated policy which could shed light on the intended treatment of donation-based equity funding.[24]

3.3 Timing

On the basis that StartUpCo will have no legal obligations or have made any binding promises to the funders in respect of the donation-based funding, and assuming that the funds are ordinary income for the reasons described above, the funds are likely to be assessable either upon receipt by StartUpCo or when they are spent.[25]

It may be argued that the possibility of a funder making a claim against StartUpCo or an action arising under Australian consumer laws for a failure by StartUpCo to deliver on its promises means that the funds are not derived until such time as StartUpCo either delivers on its promise or fails to deliver.

However, assuming StartUpCo develops its business by spending the funds it is unlikely to withhold part of those funds as a contingency that they may have to be paid back (unlike reward-based funding). This is because StartUpCo, in spending the money on its business, is carrying on the activities that it promised to undertake, which should be sufficient to ameliorate claims from the funders.

It may be that the obligations placed on StartUpCo are so vague and indeterminate that they are unenforceable, which would suggest that the funds should be assessable upon receipt.

However, if StartUpCo can identify a genuine obligation or intention to return the funds unless they have been spent developing the business it is possible that the funds should only be derived once they have indeed been spent.

4 Equity-based funding

4.1 Overview

The *Corporations Act 2001* (Cth) imposes heavy restrictions on start-ups raising equity through crowdfunding.

For example, as a proprietary company StartUpCo is only able to use equity-based funding to raise:

- up to $2m from 20 or fewer investors;[26]

[24] *First Provincial Building Society Ltd v. F.C. of T.* (1995) 56 FCR 320.

[25] *Arthur Murray (NSW) Pty Ltd v. F.C. of T.* (1965) 114 CLR 314 and *Country Magazine Pty Ltd v. F.C. of T.* (1968) 117 CLR 162.

[26] Section 708 of the *Corporations Act 2001* (Cth).

- up to $5m from 20 or fewer investors through the Australian Small Scale Offerings Board;[27] or
- funds from wholesale investors, being persons who have provided a certificate by a qualified accountant stating that the person has net assets of at least $2.5m or gross income for each of the last two financial years of at least $250,000, or both, or professional investors.[28]

StartUpCo may not be subject to the same restrictions on raising equity if it becomes a public company (a definition which includes a company with more than 50 shareholders), but it would need to issue disclosure documents and in becoming a public company it would become subject to far more onerous corporate governance and financial reporting requirements.

Recognising the incompatibility of these existing rules with equity-based crowdfunding models, Small Business Minister Bruce Billson has announced the Government's intention to introduce legislation to "develop a crowd sourced equity funding (CSEF) model." This was followed up in the 2015 Federal Budget with a proposal to draft laws that will:

> *…remove the costly elements of transitioning to a public company, enabling [StartUpCo] to more easily raise funds from a large number of small investors [and]...*
>
> *… balance supporting investment, reducing compliance costs for small businesses and maintaining an appropriate level of investor protection.*

The final form of these laws is yet to be revealed and only time will tell whether they have a material effect on the ability of Australian businesses to access equity-based crowdfunding.

4.2 Are the funds income?

In the event that StartUpCo raises funds by issuing equity interests to the funders, the immediate income tax implications of receiving the funds will change considerably from those under the reward-based and the donation based models.

To quote the majority view of the House of Lords in *Lowry (Inspector of Taxes) v Consolidated African Selection Trust Ltd* (1940) 23 TC 259, as expressed by Viscount Maugham:

> *The issue of shares by a company, whether at par or over, does not affect the profits or gains of the company for the purposes of Income Tax.*

Therefore, regardless of whether the equity interests are legal form shares or some other equity interests (i.e. a non-share equity interest[29]) the funds received for the interests should be capital in nature and should not constitute ordinary income of StartUpCo.

Further:

- the exception in section 104-35(5)(c) means that capital gains tax event D1 will not happen and, therefore, no capital gain will arise; and
- the funds will not be in the nature of a bounty or subsidy, and section 15-10 will not apply to treat the funds as assessable statutory income.

In other words, in contrast to the reward-based funding and donation-based funding models, the funds will not be income of StartUpCo. StartUpCo may, of course, be required to give up an interest in its future profits as well as voting rights and interests in

[27] Class Order 02/273 applicable to section 708 of the *Corporations Act 2001* (Cth).

[28] Section 113 of the *Corporations Act 2001* (Cth).

[29] Section 995-1(1).

its capital. These obligations would need to be weighed against, among other things, the tax cost of receiving funds under the reward-based and donation-based models.

Distributions of profits paid on the equity interests to the funders will be non-deductible for StartUpCo.[30] StartUpCo may be able to provide franking credits to its shareholders,[31] and will need to consider any withholding tax on distributions made overseas.[32]

Returns of capital paid to the funders will be non-deductible payments of capital and StartUpCo will need to consider the capital streaming and dividend substitution rules.[33]

This approach can create other issues that may need to be considered, such as the continuing availability of the tax loss in future years if there are further equity subscriptions and the business expands or changes.[34]

5 Debt-based funding

5.1 Overview

Although traditional banks may be reluctant to lend to start-ups with little or no cash flows, the potential advances of peer-to-peer or peer-to-business lending platforms may, over time, increase the availability of small business loans to borrowers such as StartUpCo.

However, it appears that the issue of debentures by StartUpCo will continue to be subject to strict regulation under the *Corporations Act 2001* (Cth) as the Government has limited its proposed crowdfunding amendments to the issue of equity and not debt. This is likely to continue to make it difficult for Australian companies to access debt-based crowdfunding.

5.2 Are the funds income?

If StartUpCo borrows the funds from the funders it will not be assessed on those funds. This is because, similar to equity-based funding, the funds will not be ordinary income, CGT event D1 will not happen (section 104-35(5)(a)) and the funds will not be a bounty or subsidy.

Interest payable to the funders should generally be deductible on an accruals basis.[35] However, in this regard:

- whether or not the interest is deductible may depend on the commercial substance of the transaction, rather than the legal form;[36]
- if the loan is a “debt interest,” meaning that it is in substance a loan arrangement, the interest should be deductible;
- in the event that the loan is not a “debt interest”, interest may still be deductible provided the loan is not an “equity interest”;
- there may be specific tax regimes that apply to StartUpCo to alter the timing of interest deductions (e.g. Division 230); and

[30] Section 26-26.

[31] Part 3-6.

[32] Section 128B of the *Income Tax Assessment Act 1936* (Cth).

[33] Section 45A and 45B of the *Income Tax Assessment Act 1936* (Cth).

[34] Subdivision 165-A.

[35] *Allianz Holdings Ltd v. F.C. of T.* (1981) 12 ATR 509.

[36] Division 974.

- StartUpCo will need to consider possible withholding tax obligations on payments of interest overseas.[37]

It is beyond the scope of this article to go into the debt and equity rules in further detail.

Any repayment of the debt principal will be non-deductible for StartUpCo.

6 Administrative guidance

To date, the ATO has not released public guidance on the income tax treatment of funds raised using the different crowdfunding models.

It should be recognised that there is a difficulty in producing broad public guidance due to the fact-specific nature of the tax rules to be applied. Different income tax outcomes may arise depending on, among other things, the purpose of the funding, whether a business is being carried on or not, the point in time at which a business commences, the nature of the arrangement with the crowdfunding platform, the source of the funds and any conditions of payment.

This lack of public guidance is consistent with the experience overseas. The US Internal Revenue Service has not issued any public guidance but is rumoured to be looking into taxpayers who have raised money through crowdfunding, while HM Revenue & Customs in the UK and the New Zealand Inland Revenue have been similarly quiet.

There is no doubt that guidance will be provided over time, which may be in the form of a public 'fact sheet' that alerts taxpayers to potential consequences rather than a formal public ruling. This would allow the ATO to set out broad principles for consideration without having to exhaustively list factual examples demonstrating how a binding interpretation should be applied.

In the meantime, the ATO has been actively looking at crowdfunding and has:

- released a paper on the GST treatment of crowdfunding;[38] and
- produced a private ruling in which it concluded that donation-based funding for a purpose not related to any income producing activity was not ordinary income.[39]

7 Conclusion

For the most part, the existing income tax regime deals appropriately with the current crowdfunding models. The exception is, perhaps, the donation-based model, where rules developed over the past century suggest that the funds should be treated as income of the recipient notwithstanding the overarching purpose of increasing the capital of the taxpayer to allow it to develop its business.

Although there are circumstances in which donation-based funding will not be income, the risk that it is income and therefore assessable early in the life of the business will need to be addressed by a taxpayer who raises any material amounts using this model.

It may also be the case that taxpayers are surprised to learn of the taxable nature of reward-based funding where a business is being carried on, and will need to undertake work to identify whether there is a business being carried on and the consequences of not carrying on a business, including the impact on the deductibility of expenditure.

[37] Section 128B.

[38] Australian Taxation Office, 'GST and Crowdfunding' (13 November 2014).

[39] Private ruling authorisation number 1012707220484.

These and any other continuing uncertainties over the income tax implications may, over time, affect the wider adoption of crowdfunding.

Finally, an additional word of caution: this article only considers Australian income tax consequences. In the event that funds are sourced from overseas there may be foreign tax consequences as well!

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