TAX INCENTIVES FOR INVESTMENT CROWDFUNDING: A COMPARATIVE ANALYSIS

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INTRODUCTION 235
I. U.K. TAX BENEFITS FOR ENTERPRISE INVESTMENTS 239
II. U.S. TAX BENEFITS FOR CAPITAL INVESTMENTS 243
A. Entity-Level Taxation 244
B. Federal Tax Incentives for Investor-shareholders 245
C. State Tax Credits for Investor-shareholders 250
III. REFLECTIONS ON THE USE OF TAX INCENTIVES IN THE CONTEXT OF INVESTMENT CROWDFUNDING 254

INTRODUCTION

Crowdfunding is a widely used method for individuals to raise funds, whether it be for a charitable purpose, a business, or a specific event.[1] As online crowdfunding campaigns have become more common, a question arises—what role does tax law play in that phenomenon? Crowdfunding has been around for centuries and has been used to help fund anything from creative projects to

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1. *See generally* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 10 (2012) (providing a taxonomy of crowdfunding transactions); SEC Proposal on Crowdfunding, 78 Fed. Reg. 66,428, 66,429 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249) ("Crowdfunding is a new and evolving method to raise money using the Internet. Crowdfunding serves as an alternative source of capital to support a wide range of ideas and ventures. An entity or individual raising funds through crowdfunding typically seeks small individual contributions from a large number of people."); *see also* Thomas Murphy, *Playing to a New Crowd: How Congress Could Break the Status Quo by Raising the Cap on the Jobs Act's Crowdfunding Exemption*, 58 B.C. L. REV. 775, 775 (2017) (noting "[c]rowdfunding technology allows any entrepreneur with an Internet connection the opportunity to pitch an idea to a community of investors, which could revolutionize the market for early-stage startup financing.").

humanitarian causes to for-profit transactions.[2] Since the 1990s, online platforms have been the preferred method of conducting crowdfunding campaigns as well as a creative way for companies to raise capital from the larger general public through the sale of securities.[3] The success and popularity of such efforts resulted in movements favoring such creative avenues of funding, which in turn led regulatory authorities to expand the regulations to cover transfers of this kind.[4]

The tax consequences of crowdfunding are diverse.[5] A fundamental principle in taxation is that all accessions of wealth

2. *See, e.g.*, Andrew Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1469 (2013) (estimating that lawyers, underwriters, and accountants must spend over 1200 hours on securities registration); David Mashburn, Comment: *The Anti-Crowd Pleaser: Fixing the Crowdfund Act's Hidden Risks and Inadequate Remedies,* 63 EMORY L.J. 127, 130 n.15 (2013) (warning that "for startups, and none of the other registration exemptions fits equity crowdfunding"); Richard A. Epstein, *The Political Economy of Crowdsourcing: Markets for Labor, Rewards, and Securities*, 82 U. CHI. L. REV. DIALOGUE 35, 47 (2015) (discussing the forces and incentives of market players in the crowdfunding platform).

3. *See* Jason W. Parsont, *Crowdfunding: The Real and The Illusory Exemption*, 4 HARV. BUS. L. REV. 281, 284 (2014) (claiming that accredited crowdfunding may face a long-term lemons problem on account of rules that discourage investors from fending for themselves).

4. *See, e.g.*, Sean M. O'Connor, *Crowdfunding's Impact on Start-Up IP Strategy*, 21 GEO. MASON L. REV. 895, 896 (analyzing the current state of crowdfunding and the possible advantages it offers to new businesses, particularly with relation to intellectual property); Joan MacLeod Heminway, *Crowdfunding and the Public/Private Divide in U.S. Securities Regulation*, 83 U. CIN. L. REV. 477, 477–81 (2014) (exploring the inception and growth of crowdfunding and its interplay with U.S. securities regulations); Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 339 (2013) (describing the significant support in both Congress and the White House received for the practice of crowdfunding and other forms of small business finance).

5. *See Money Received Through "Crowdfunding" May Be Taxable; Taxpayers Should Understand Their Obligations and the Benefits of Good Recordkeeping*, IRS (Mar. 2022), https://www.irs.gov/newsroom/money-received-through-crowdfunding-may-be-taxable-taxpayers-should-understand-their-obligations-and-the-benefits-of-good-recordkeeping [https://perma.cc/2CXF-6RMR] (Merely receiving a 1099-K does not automatically necessitate the payment of taxes on the income it discloses. If the individual fails to declare the payments from the form on their tax return, the IRS may reach out to the recipient to request further information. The donor may be required to provide a rationale for excluding crowdfunding contributions. Individuals participating in crowdfunding initiatives, either as organizers or recipients, should maintain comprehensive documentation for a minimum duration of three years. Contributions made by individuals to a crowdfunding campaign are considered gifts when they are given selflessly, without any anticipation of receiving anything in return. Consequently, they will not be included as part of the beneficiary's total income. Under federal tax regulations, all funds, regardless of their origin, are classified as gross income unless explicitly exempted, such as in cases of gifts or charitable donations. Crowdfunding is a simple and profit-driven transaction where cash is transferred in return for shares and occasionally extra benefits.)

clearly realized over which the taxpayer has complete dominion are considered taxable gross income for federal tax purposes unless explicitly exempted.[6] Crowdfunding revenues are a form of "accession of wealth" clearly realized to the platform company over which they have complete dominion.[7] Accordingly, depending on the terms of the crowdfunding campaign and the intentions of the participants, such amounts may be subject to taxes to the company that receives them or may be considered gifts or charitable contributions exempt from tax to the receiver and might provide a charitable deduction to the donor.[8] Different tax consequences follow whether the crowdfunding model includes rewards, donative intent, or a non-profit entity.[9] Yet, this is not the focus of this essay.

"Investment Crowdfunding" is a unique form of funding a venture via several individuals' monetary contributions.[10] It entails a more direct and profit-driven provision of funds in exchange for stock.[11] This investment vehicle was introduced in an effort to rejuvenate the economy in the aftermath of the 2008 recession, and in reaction to some enterprises providing shares in return for public

6. 26 U.S.C. §61(a); *see* Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955) (determining taxable income includes any "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.").

7. *See* Darian M. Ibrahim, *Crowdfunding Signals*, 53 GA. L. REV. 197, 199 (2018) (demonstrating that while companies primarily crowdfund to raise capital, they also use such campaigns to signal firm quality and productivity); *see also* Bradford, *supra* note 1, at 29 (describing the effect of merging of crowdsourcing and microfinance).

8. *See, e.g.*, Joan MacLeod Heminway, *What Is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 335, 356–61 (2012) (elucidating the various kinds of crowdfunding and the financial stakes of crowdfunded businesses).

9. *See generally* IRS, *supra* note 5 and accompanying text. *See also* I.R.S. Priv. Ltr. Rul. 2016-0036 (Mar. 30, 2016), https://www.irs.gov/pub/irs-wd/16-0036.pdf [https://perma.cc/8WWD-8S28] ("[T]he income tax consequences to a taxpayer of a crowdfunding effort depend on all the facts and circumstances surrounding that effort.").

10. *See generally* ANDREW A. SCHWARTZ, INVESTMENT CROWDFUNDING 32 (2023) (defining crowdfunding); Patricia H. Lee, *Crowdfunding Capital in the Age of Blockchain-Based Tokens*, 92 ST. JOHN'S L. REV. 833, 890 (2018) ("Investment crowdfunding company offerings include a range of common stock, convertible debt, tokens and coins offered to investors."); Lynnise E. Phillips Pantin, *What's Wrong with Jumpstart(ing) Our Business Startups, (JOBS) Act?*, 16 N.Y.U. J.L. & BUS. 185, 201 (2019) ("Investment crowdfunding involves companies making an offering for sale of securities to the general public using the internet."); Jack Wroldsen, *Crowdfunding Investment Contracts*, 11 VA. L. & BUS. REV. 543, 546 (2017) (describing that such investments are offered through various different registered crowdfunding investment websites ("funding portals") and broker-dealers authorized to conduct crowdfunding investment transactions).

11. *See* SCHWARTZ, *supra* note 10, at 3 ("Investment crowdfunding works much the same way, except instead of getting a physical product or some other reward, investors receive a financial interest in the company.")

online contributions via crowdfunding.[12] In 2012, Congress passed the Jumpstart Our Business Startups Act ("JOBS Act"), allowing some firms to participate in equity crowdfunding transactions online.[13] Although the JOBS Act eased registration criteria for smaller firms, the latest regulations require companies to fulfill various conditions to be eligible for exemption under the rules.[14] Moreover, these companies are subject to ongoing scrutiny and inspections by the Securities Exchange Commission ("SEC") to uphold their qualified status.[15] It is also necessary for them to maintain precise financial records in the event that they are subject to scrutiny.[16]

When comparing investment crowdfunding activity in the United States ("U.S.") and other countries such as Australia, Canada, and the European Union, Professor Andrew Schwartz theorizes in his recent book *Investment Crowdfunding* that perhaps the fact that the United Kingdom ("U.K.") has special tax benefits, though not specific to crowdfunding, is the reason for the discrepancy and why numbers in other countries are higher than when compared to the U.S.[17] Having this claim in mind, Part I of this essay will delve into the U.K. tax treatment of investment crowdfunding. Part II will demonstrate that while not termed to apply specifically to crowdfunding investors (aside from the one case of the State of Virginia), the U.S. provides general investment incentives for investors in small business stock that, under specific requirements, may apply to investment crowdfunding as well. In Part III, the essay will reflect on the issues arising from the tax treatment of investment crowdfunding by deriving insights from the U.S. and the U.K. tax models. It will also offer suggestions to increase effectiveness and salience in the area.

12. *Id.* at 32.

13. The Jumpstart Our Business Startups Act, Pub. L. No. 112-106,126 Stat. 306 (2012) (noting that Title III of the Jumpstart Our Business Startups Act is the CROWDFUND Act).

14. *See* 17 C.F.R. §227.100(a); U.S. Sec. & Exch. Comm'n, Report to the Commission: Regulation Crowdfunding 3, 6 (2019), https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf [https://perma.cc/FVT3-PJZ8].

15. Schwartz, *supra* note 2, at 1486 (explaining the requests for records and documents, as well as the enforcement of shareholder resolutions).

16. *Id.* at 1485; *see also* SCHWARTZ, *supra* note 10 and accompanying text.

17. SCHWARTZ, *supra* note 10, at 36–37.

I. U.K. TAX BENEFITS FOR ENTERPRISE INVESTMENTS

Crowdfunding in the U.K. has become a popular method for individuals and businesses to raise funds for various projects or ventures.[18] Equity or investment crowdfunding platforms are regulated by the Financial Conduct Authority ("FCA").[19] Companies seeking to raise funds through equity crowdfunding must comply with certain disclosure requirements. The FCA limits the amount of funds that firms may raise via crowdfunding and also limits the eligibility of corporations for tax relief based on the investors from whom they receive capital.[20] Such limitations differ based on the types of portfolio companies on the investment crowdfunding platforms. Specifically, small and established companies that focus on research or innovation have the ability to raise more funds compared to other companies.[21]

The U.K. provides certain tax benefits for individuals investing in crowdfunding through certain schemes designed to encourage investment in early-stage and growth companies by providing tax relief for a certain proportion of their qualifying investments.[22] Termed "Enterprise Investment" programs, they vary in the percentages and quantities that may be claimed. There is a risk-to-capital requirement, which prohibits corporations from seeking coverage under these programs if they engage in capital preservation.[23] These rules were designed to incentivize investors to undertake risks rather than benefitting from contributing to the

18. *See, e.g.*, Shruti Rana, *Philanthropic Innovation and Creative Capitalism: A Historical and Comparative Perspective on Social Entrepreneurship and Corporate Social Responsibility*, 64 ALA. L. REV. 1121, 1167 (2013) (comparing the regulatory framework for crowdfunding in the U.S. to the U.K. and concluding that lack of recognition and regulatory action means that "the regulatory framework governing crowdfunding enterprises in the United States is falling significantly behind the regulatory framework in the UK.").

19. *See generally* FINANCIAL CONDUCT AUTHORITY, https://www.fca.org.uk/ [https://perma.cc/3CJU-9CWC] (last visited Apr. 14, 2024).

20. *See* Robert H. Steinhoff, *The Next British Invasion Is Securities Crowdfunding: How Issuing Non-Registered Securities Through the Crowd Can Succeed in the United States*, 86 U. COLO. L. REV. 661, 693–94 (2015) (describing new rules the FCA promulgated to allow privately held businesses to raise capital by selling non-registered equity and debt securities to the general public).

21. *See* Rana, *supra* note 18, at 1166.

22. *See* Carlos Berdejo, *Financing Minority Entrepreneurship*, 2021 WIS. L. REV. 41, 96 (2021) ("A number of programs in the U.K. offer favorable tax treatment to investors participating in crowdfunding issuances by small companies.").

23. Mashburn, *supra* note 2, at 136 (discussing risk assessment in crowdfunding).

preservation of capital.[24] Generally speaking, in the U.K. contributions of capital to a company are exempt from taxation at the entity level, provided they are used only for the purpose of exchanging equity in the firm.[25] A research and development credit provides tax relief for up to 35 percent of the amount spent on activities that meet the criteria. Yet, there are three specific programs in the U.K. that aim to assist small and medium-sized businesses in expanding by luring investments and providing tax relief to individuals: The Enterprise Investment Scheme ("EIS"), the Seed Enterprise Investment Scheme ("SEIS"), and the Venture Capital Trust ("VCT").[26] These incentive programs are subject to several industry restrictions.[27]

The U.K. has limitations on the maximum amount of funds that may be invested via the various enterprise investment programs. Initiated in 1994, the EIS program aims to enhance the appeal of investing in shares of early-stage enterprises by providing tax relief to investors.[28] The EIS and VCT programs have

24. *See generally Tax Relief for Investors Using Venture Capital Scheme*, HM REVENUE & CUSTOMS, https://www.gov.uk/guidance/venture-capital-schemes-tax-relief-for-investors [https://perma.cc/SVW9-W6G9] (Oct. 6, 2023).

25. *See generally Use the Enterprise Investment Scheme to Raise Money for Your Company*, HM REVENUE & CUSTOMS (July 11, 2019), https://www.gov.uk/guidance/venture-capital-schemes-apply-for-the-enterprise-investment-scheme [https://perma.cc/Z6ZC-7USR].

26. A fourth program—the Social Investment Tax Relief ("SITR") program—became unavailable effective April 2023. *IMPORTANT – As of 5 April 2023 SITR Is No Longer Available*, GET SITR, https://www.getsitr.org.uk/#:~:text=Please%20note%20as%20of%205,SITR%20is%20no%20longer%20available.&text=Unlike%20more%20commercial%20businesses%2C%20many,affordable%20and%20risk%2Dbaring%20capital [https://perma.cc/WVP9-ZHJA] (last visited May 15, 2024).

27. *Use a Venture Capital Scheme to Raise Money for Your Company*, HM REVENUE & CUSTOMS (Jan. 1, 2016), https://www.gov.uk/guidance/venture-capital-schemes-raise-money-by-offering-tax-reliefs-to-investors#the-seed-enterprise-investment-scheme-seis [https://perma.cc/T6V6-G4UN] (These incentives have Industry limitations such as: coal or steel production, farming or market gardening, leasing activities, legal or financial services, property development, running a hotel, running a nursing home, generation of energy such as electricity and heat, production of gas or other fuel, exporting electricity, banking, insurance, and debt or financing services.)

28. *EIS Qualifying Criteria*, OCTOPUS INV., https://octopusinvestments.com/resources/guides/eis-guide/eis-qualifying-criteria/ [https://perma.cc/LUS4-DH33] (last visited Apr. 14, 2024) (Currently, businesses engaged in the activities listed below are not eligible for EIS funding: Engaging in land transactions, property development, and leasing, engaging in the trade of commodities that are not typically sold via regular retail or wholesale channels, engaging in the trading of financial instruments, providing banking services, offering insurance products, facilitating hire purchase agreements, providing money lending services, and conducting other financial operations, receipt of royalties or

particular eligibility criteria for companies, including a maximum of £15 million in gross assets, fewer than 250 workers, and active sales for no more than seven years.[29] These programs provide four main types of tax benefits, including income tax relief, tax-free growth, capital gains deferral, and loss relief. Under the income tax relief, investors may get up to a 30 percent deduction on their qualified investments, reducing their taxable income. For example, an individual who invests $1 million can get up to $300,000 claimed as a deduction.[30] The tax-free growth aspect refers to the absence of taxes on the increase in value of an investment when EIS shares are sold.[31] This is particularly noteworthy since tiny, early-stage enterprises have a considerable likelihood of experiencing substantial growth in value. Capital gains deferral provides a major advantage by allowing reinvestment of profits from the sale of assets into EIS shares and postponing the payment of taxes on that profit for the duration of the investment.[32] There is no maximum restriction on the value of profits that may be postponed. Lastly, loss relief allows for deduction of losses incurred by EIS firms, which helps mitigate the negative effect of these losses.[33]

The VCT Program offers funding for novel and innovative businesses. A VCT is a certified organization in the U.K. that makes investments or provides loans to unlisted companies according to

license fees, provision of legal and accounting services, agriculture and horticulture for commercial purposes, forestry operations, hotel or residential care home operations or management, coal production, steel manufacture, and shipbuilding, and all activities related to energy generation.).

29. *See* Chris Godfrey, *EIS – the Enterprise Investment Scheme Explained*, SWOOP FUNDING (Jan. 2, 2024), https://swoopfunding.com/uk/equity-financing/eis-enterprise-investment-scheme/ [https://perma.cc/T89A-NBCH].

30. *Id.*

31. *What Is EIS Investment? EIS Schemes Explained – Definitions and Meaning*, EMV CAP. (June 16, 2023), https://emvcapital.com/what-is-eis-explained/ [https://perma.cc/YDX4-A9XM].

32. *See* Joseph J. Dehner & Jin Kong, *Equity-Based Crowdfunding Outside the USA*, 83 U. CIN. L. REV. 413, 426 (2014) (comparing different crowdfunding regimes and concluding the EIS tax relief is a prominent incentive for crowd investors in the U.K.).

33. *Tax Relief for Investors Using Venture Capital Scheme*, *supra* note 24 (explaining the process for claiming deductible loss equal to the sale proceeds received minus the effective cost (the amount invested minus whatever was claimed in income tax relief)). *See also Use a Venture Capital Scheme to Raise Money for Your Company*, *supra* note 26 (explaining many EIS restrictions, such as the money invested must be used to buy new shares, not shares already in existence. The investment must meet the risk to capital condition, i.e. have the intention to grow and develop its trade over the long term pose a risk to the investors' capital. The shares must be full risk ordinary shares which are not redeemable and carry no special rights to assets.).

certain conditions, as approved by the U.K. tax authorities.[34] The VCT cannot have total assets that surpass £15 million (£16 million after the investment) or more than 250 workers (500 for knowledge-intensive ("KIN") companies).[35] The company's trading duration must not exceed seven years, with the exception of KIN companies, which may trade for a maximum of ten years.[36] VCTs may get up to a 30 percent reduction in income tax on the amount invested, provided they hold onto the shares of the portfolio firm for at least five years. The investment funds of the VCT must be used to achieve growth objectives, such as augmenting revenue, expanding the client base, and growing the number of workers.[37] The cash should not be allocated for the purpose of sustaining the firm, such as paying current daily operational expenses. Furthermore, it is impervious to external control from any other corporation.

Lastly, the SEIS allows firms to qualify if they are less than two years old and meet the following criteria at the time of investment: They have no more than £350,000 in gross assets, have fewer than twenty-five workers, and have not engaged in a different trade of business. SEIS investors are eligible for a tax relief that enables them to claim tax reduction on 50 percent of their assets and exempts them from paying any capital gains tax.[38] In order to qualify for these tax advantages, the U.K. tax authorities must provide investors with a letter of approval, a distinctive reference

34. *See* SIMON HOWLEY, CORPORATE TRANSACTIONS Part C Joint ventures, Chapter 12 Joint Venture Company – Preliminary Considerations, 1 Taxation, Butterworths Corp. L. Serv. (UKBCLS) (Aug. 2, 2022).

35. Kirsty MacSween, *What Is a Knowledge Intensive Company (KIC)? EIS Benefits and Criteria*, SEED LEGALS (May 7, 2019), https://seedlegals.com/resources/what-is-a-knowledge-intensive-company-the-criteria/#:~:text=Knowledge%20Intensive%20Companies%20(KICs)%20are,flexibly%2C%20than%20non%2DKICs [https://perma.cc/E3W7-QUFL]; FIN. CONDUCT AUTH., https://www.fca.org.uk/ [https://perma.cc/U5GU-F8DC] (last visited Apr. 14, 2024) (A knowledge-intensive company ("KIC") is a corporation that primarily focuses on research and development ("R&D") as its principal commercial activity).

36. *See* CORPORATE TRANSACTIONS Part A Share and Business Sales, Chapter 2 Preparations for Sale, 2 The Seller's Preparations (Vendor due Diligence and Pre-Sale Grooming), Butterworths Corp. L. Serv. (UKBCLS) (Aug. 2, 2022).

37. *VCM8130 - Venture Capital Schemes: The Changes in Detail: Growth & Development*, GOV U.K. (Mar. 9, 2016), https://www.gov.uk/hmrc-internal-manuals/venture-capital-schemes-manual/vcm8130 [https://perma.cc/5B3Q-APRU]; *See also* COMPANY LAW, Part A Formation, Chapter 1 Types of Business Medium, 2 Types of Company Butterworths Corporate Law Service (UKBCLS) (Aug. 2, 2022).

38. *The Seed Enterprise Investment Scheme (SEIS)*, CROWDCUBE, https://www.crowdcube.com/explore/investing/tax-relief/seis [https://perma.cc/D4Z5-ZTFV] (last visited Apr. 14, 2024) (detailing a limit on the initial tax reduction of up to £100,000, separate from the unlimited 50 percent capital gains exemption).

number, and a compliance certificate.[39] Although these tax benefits are not provided solely, nor designated, for firms engaged in investment crowdfunding, they are easily applied in the U.K., are advantageous to investors, and spur their engagement in such activity.[40]

As explained in the following section, tax treatment of investment crowdfunding in the U.S. is structured in a similarly loose manner and offers many of the same opportunities for savvy investors, despite focusing on small businesses and including certain limitations that may make its application more complex.

II. U.S. TAX BENEFITS FOR CAPITAL INVESTMENTS[41]

Entrepreneurial ventures and their investors navigate a complex landscape of tax implications within the U.S. This Part will delve into the intricacies of these tax considerations, shedding light on the multifaceted challenges and opportunities that arise. The tax landscape for entrepreneurial companies is dynamic and varies significantly from state to state. Understanding these intricacies is crucial for businesses seeking optimal fiscal strategies. In the subsequent discussion, these nuanced tax advantages for small business investments that are also available to both investors and entrepreneurial entities will be explored providing comprehensive insights that empower stakeholders to make informed decisions.

This Part will reveal that the rules in the U.K. and the U.S. are quite similar and, at their core, aim to foster investments in small business ventures. Aside from the state of Virginia, the tax benefits granted in the U.S. to investors in small business stock apply generally and are not specific to funds raised via crowdfunding. Accordingly, the following Part will scrutinize these rules within the financial paradigm of crowdfunding platforms as a

39. *Tax Relief for Investors Using Venture Capital Scheme*, *supra* note 24. Taxpayers must submit form SEIS3 and include the following information: the company has to have a permanent establishment in the U.K. with no more than 250 employees (500 for KIN) and total value of no more than £15 million before investment and £16 million after investment. There has to be a risk to capital—the investment can't be structured to provide a low-risk investment, capital must inherently include risk, the money collected must be used towards achieving growth objectives, the cash should not be used towards sustaining the firm, such as paying pre-existing daily operational expenses, the business's trading duration cannot exceed seven years (ten years for KIN).

40. *See* SCHWARTZ, *supra* note 10, at 36 (describing the tax benefits for firms in the U.K.).

41. There are different tax consequences when the crowdfunding model includes rewards or donations to a non-profit entity. This is not the focus of this paper.

means of capital infusion. While such platforms offer a democratized approach to fundraising, they introduce a unique set of challenges.

A. Entity-Level Taxation

When investors add capital to a new corporation, the Internal Revenue Code ("IRC") section 351 states that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons control the corporation.[42] Therefore, assuming all requirements are met, contributed funds raised by crowdfunding companies are not considered income to the entity. No gain or loss is recognized when participants contribute cash to a crowdfunding campaign in exchange for ownership in a corporation because money is considered property.[43] During the life of the corporation, the IRC explicitly states that if an investor receives rewards or benefits from a corporation in addition to an equity position, the investor must recognize gain (but not loss) equal to the fair market value of the property or benefit received.[44]

If the crowdfunding investment is made through a partnership and the investors receive no additional benefits for their participation, then the crowdfunding investors' basis in the partnership will be equal to the amount of money they put into the partnership.[45] In general, distributions of property from a partnership to a partner do not result in gain to the partner if the partner's basis in the partnership exceeds the value of the distribution from the partnership and the distributions are out of operating cash flow, guaranteed payments, or preferred returns.[46] Yet, under certain conditions, Treasury Regulations provide that if transactions are determined to be a sale or exchange, then

42. 26 U.S.C. §351(c). "Control" is defined by 26 U.S.C. §368(c) ("[T]he term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.").

43. *Id.* Property (e.g., crypto) exchanged solely for equity could be tax-free capital contributions under §1032.

44. *See* 26 U.S.C. §61(a).

45. H.R. Rep. No. 116-122, at 67 n.76 (2020), https://www.sec.gov/files/report-congress-regulation.pdf [https://perma.cc/5A3Q-MGUJ] ("A limited secondary market for private securities exists, which includes the market for limited partnership (LP) interests in private funds and the direct market for the stock of private companies.").

46. *Id.*

nonrecognition under partnership rules do not apply and the partner needs to recognize gain.[47] In the context of crowdfunding, various factors would support the assertion that offering benefits or rewards in conjunction with a partnership interest constitutes a sale as defined in the Regulations.[48] However, as we shall see next, the main problem of investment crowdfunding through a partnership is the ineligibility for federal and state tax benefits that require the portfolio companies to be incorporated.

B. Federal Tax Incentives for Investor-shareholders

Tax incentives are provided to investors in order to promote investment in small businesses. A designated category of stock known as Qualified Small Business Stock ("QSBS") is eligible for several tax advantages within the United States.[49] The legislative intent behind this tax benefit was to encourage people to invest in small businesses and to foster their growth by offering incentives for high-tech startup companies and stakeholders that invested in such companies.[50] Similar to the U.K. VCT program, policies of promoting entrepreneurship, innovation, and job creation were behind this incentive for entrepreneurial equity capital formation.[51] In order to qualify for the benefit, the stock must have been issued by a domestic C corporation that satisfies the requirements of a "qualified small business" at the moment of stock issuance. A small business corporation is a company whose total assets must not surpass $50 million at the moment stock is

47. 26 U.S.C. §707.

48. *Id.* These factors include the fact that (1) the investor provides funds to the partnership with the understanding that the timing and magnitude of the reward or perks transfer will be reasonably certain; (2) the investor will acquire a legally enforceable right to the promised perks or rewards when the partnership spends that investor's money; (3) additional investors are required to contribute monetary funds in order for the partnership to offer the promised perks or rewards; and (4) a partner is not obligated to make any monetary contributions. Such factors were added in section 707 to prevent abuses by partnerships in which the contributor attempts to evade the recognition of gain on the contributed property.

49. The tax code defines a qualified small business stock as that of a C corporation with less than $50 million in aggregate gross assets. 26 U.S.C. § 1202(d). *See generally* Mirit Eyal-Cohen, *Down-Sizing the "Little Guy" Myth in Legal Definitions*, 98 IOWA L. REV. 1041, 1081 (2013) (outlining various tax benefits to small businesses including the QSBS).

50. Eyal-Cohen, *supra* note 49, at 1082.

51. *Id.* at 1083.

issued.[52] Additionally, a minimum of 80 percent of the company's assets must be utilized in the active operation of a qualified trade or business.[53]

The framework for the exclusion of gain realized from the sale of qualified small business stock is outlined in IRC section 1202. The principal tax benefit to investors possessing QSBS is the possibility of having a portion or the entirety of the gain realized upon the stock's sale or exchange excluded.[54] Yet, this exclusion is subject to specific limitations and conditions. In general, for an investor to qualify for the exclusion, the QSBS must be held for a minimum of five years.[55] Additionally, rules pertaining to the manner in which the stock was initially issued, and the nature of the assets possessed by the organization also apply. Only if all those conditions are fulfilled can investors benefit from the exclusion of QSBS gain from income, a notable tax advantage.[56]

Nonetheless, prior to investors reaping such tax preference there are substantial hurdles to surpass. In order to meet the requirements of section 1202, the portfolio business must be a domestic C corporation and cannot be a partnership or a Limited Liability Company ("LLC").[57] Additionally, it cannot be operating in certain industries such as hotel, farm, mining, restaurant,

52. 26 U.S.C. §§ 1202(c)(1), (d)(1)(B). *See also* Mirit Eyal-Cohen, *Legal Mirrors of Entrepreneurship*, 55 B.C. L. REV. 719, 768 (2014) (providing an overview of the tax incentives to investors of small business stock).

53. 26 U.S.C. § 1202(e)(1)(A) ("at least 80 percent (by value) of the assets of such corporation are used by such corporation in the active conduct of 1 or more qualified trades or businesses . . . .").

54. *Id.* § 1202(a)(1) (providing that for "a taxpayer other than a corporation gross income shall not include 50 percent of any gain from the sale or exchange of qualified small business stock held for more than 5 years."). Yet, for the years 2010 and onward, section 1202(a)(4) provides up to 100 percent exemption on QSBS gains calculated as up to $10 million of gains or 10x cost basis. *Id.* § 1202(a)(4).

55. *Id.* § 1202(a)(1).

56. *Id.* § 1202(d)(2). This section provides "[a]ggregate gross assets (A) In general. For purposes of paragraph (1), the term "aggregate gross assets" means the amount of cash and the aggregate adjusted bases of other property held by the corporation. (B) Treatment of contributed property. For purposes of subparagraph (A), the adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution."

57. *Id.* § 1202(e)(4) (defining the term "eligible corporation" to mean "any domestic corporation").

financial, architecture, law, or engineering.[58] Only common or preferred shares, rather than convertible notes or Simple Agreements for Future Equity ("SAFEs"), constitute permittable types of investment equity investors can receive to be eligible for the tax benefit. Investors have to obtain these shares directly from the issuing company (i.e., not through a secondary market transaction) as the initial purchaser. It is imperative that the equity offered will be that of a small business (i.e., the company's assets do not surpass $50 million in total value or immediately after issuance).[59] The company must fulfill specific active business prerequisites, including allocating a minimum of eighty percent of its assets towards the operational activities of one or more qualified enterprises.[60] Aside from whether or not taxes may still be owed at the state level and whether the issuer purchased any stock from the taxpayer, there are many other nuances and complexities associated with QSBS and section 1202.[61]

Qualifying as a small business also provides benefits for investors in case of losses. Individual investors who sold QSBS that qualifies as "section 1244 stock" receive ordinary loss treatment (instead of capital losses) in regard to losses suffered as a result of the sale or depreciation of qualifying small business stock.[62] The differentiation between ordinary and capital losses is noteworthy due to the fact that ordinary losses might be entirely deductible in

58. *Id.* §§ 1202(e)(1)(A), (e)(3). Section 1202(e)(1)(A) requires "at least 80 percent (by value) of the assets of such corporation are used by such corporation in the active conduct of 1 or more qualified trades or businesses." Section 1202(e)(3) defines qualified trade or business as "any trade or business other than—(A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees, (B) any banking, insurance, financing, leasing, investing, or similar business, (C) any farming business (including the business of raising or harvesting trees), (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and (E) any business of operating a hotel, motel, restaurant, or similar business."

59. *Id.* § 1202(d)(1).

60. *Id.* § 1202(e)(1)(A).

61. On the complexity of section 1202, see Gregg Polsky & Ethan Yale, *A Critical Evaluation of the Qualified Small Business Stock Exclusion*, 42 VA. TAX REV. 353, 363 (2023) ("Section 1202 is an extremely complex and multifaceted rule."). *See generally* Michael Yuhas & Carl C. Radom, *Section 1202 - Hidden Gem or Paradise Lost?*, 137 J. TAX'N 9 (2022).

62. 26 U.S.C. § 1244(a) ("In the case of an individual, a loss on section 1244 stock issued to such individual or to a partnership which would (but for this section) be treated as a loss from the sale or exchange of a capital asset shall, to the extent provided in this section, be treated as an ordinary loss.").

comparison to ordinary income, thereby potentially offering a more advantageous tax treatment.[63] On the other hand, capital losses are limited in their deductibility against capital gains and taxed at lower rates or carried over to the following years.[64]

There are still many limitations of the ability to benefit from section 1244 ordinary losses.[65] It is worth noting that for the stock to qualify for treatment under section 1244, it must have been issued by a domestic corporation and at the time of issuance, the corporation's total capitalization cannot exceed $1 million, and the sale of the stock must be for cash or tangible assets.[66] Only individual investors are eligible to receive the advantages of ordinary losses under section 1244, as opposed to corporations or other types of entities. Moreover, individual investors are limited to a maximum allowable ordinary loss of $50,000 per year ($100,000 for joint filers) and the reporting in their tax return of such losses in the case of sale of section 1244 stock on their tax returns has to include a separate statement that details the corporation and the stock.[67] Yet, given that these losses are being classified as ordinary losses rather than capital losses, and that the annual deduction limit for ordinary losses is increased from $3,000 to $50,000 ($100,000 for joint filers), saliant taxpayers with savvy tax advisers may endure such complexity due to the tax savings these losses deliver.

In the context of the portfolio company, in order for its investors to qualify for section 1244 loss it must satisfy many criteria.[68] For example, at the time of stock acquisition, aside from the company being a C- or S-corporation, the acquisition of shares can only be via the exchange of cash or property, excluding any transactions involving services or stock/securities. The stock has to be obtained directly from the issuing company, rather than via a secondary sale. The capital paid for the stock has to constitute a portion of the first $1 million funds raised by the issuer, and for the five years prior to the loss, the corporation must get at least fifty percent of its gross revenues from an active trade, excluding income

63. *Id.* § 1(h) (applying a rate of 15 percent or 20 percent on net capital gain calculated by deducting capital losses against capital gains).

64. Capital losses can also offset $3,000 of ordinary income. 26 C.F.R. § 1.1211-1 (1980) (providing limitations on offsetting capital losses).

65. *See, e.g.*, 26 U.S.C. § 1244(b)–(c) (placing limitations on the maximum amount that can be deducted, the type of stock defined as qualified, etc.).

66. *Id.* § 1244(c)(3).

67. *Id.* § 1244(b)(1)–(2).

68. *Id.* § 1244(c).

from royalties, rentals, dividends, interest, and similar sources.[69] What happens if a firm raises over $1 million in a single funding round or if a subsequent funding round pushes the total raised amount above the $1 million mark? Usually, the corporation would be required to allocate the first $1 million as section 1244 shares. Alternatively, the 1244 reduction would probably be distributed across all the money raised in that particular round.[70] Employees joining the start-up later usually do not benefit from the QSBS exclusion.[71] Efficient documentation may help save time in the future; thus, maintaining meticulous records of fundraising history for each crowdfunding portfolio firm is essential in order to facilitate the future assessment of whether stock qualifies as 1244 shares.[72]

Lastly, a particular provision within the Code—section 1045—permits the deferral of capital gains taxes on the sale of QSBS.[73] This rule, also known as "section 1045 rollover," provides a tax deferral benefit upon reinvestment of capital by an individual or partnership of QSBS stock using such proceeds to purchase another QSBS within a specified time period.[74] The rollover benefit provides an advantage to serial investors by allowing them to rollover their basis of one QSBS to another QSBS, deferring the tax on the gain to a later realization event. For taxpayers with a QSBS investment holding period of six months or longer but less than five years, there is a possibility that they can transfer their gains to another QSBS investment within sixty days and thereby postpone tax payment on said gains.[75] Upon holding the new QSBS investment for a cumulative period of five years (including the holding period of the original QSBS and the new holding period), taxpayers might qualify for the tax-free exemption under section 1202 when they sell the new QSBS.

To illustrate, a taxpayer who holds Startup A's QSBS for a duration of two years and subsequently invests in Startup B's

69. *Id.* § 1244(c)(1)(C) ("[S]uch corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.").

70. Yuhas & Radom, *supra* note 61, at 10.

71. Polsky & Yale, *supra* note 61, at 386.

72. *Id.* at 398 (criticizing that "even if firms do keep accounting records at the granular level the statute demands, the rule creates incentives that run counter to the justification for the gain exclusion in the first place.").

73. 26 U.S.C. § 1045(a).

74. *Id.* § 1045(b)(3).

75. 26 C.F.R. § 1.1045-1(d)(2) (2007).

QSBS through a section 1045 Rollover would be required to postpone the sale of Startup B's stock for a mere three years to satisfy the five-year holding period requirement, in order to pertain to the sale of small business stock that satisfies the other requirements specified in section 1202. Yet, in order to qualify for 1045 treatment for the year of the transaction, the taxpayer can file a special election. The tax deferral of gains under section 1045 will remain in effect at the time of conversion, irrespective of whether the newly-converted QSBS ultimately fulfills the five-year holding period or not. Nevertheless, because both the rollover and the initial investment must be denominated in QSBS both entities issuing these stocks must be C-corporations rather than other types of entities.[76]

C. State Tax Credits for Investor-shareholders

Although bills to enact similar benefits failed at the federal level,[77] there are over thirty states that offer angel tax credits to incentivize investors in seed capital ventures.[78] Angel tax credits

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76. 26 U.S.C. § 1045(b)(1) (defining "qualified small business stock" by referencing § 1202(c), which requires the stock to be in C corporation only). *See* Polsky & Yale, *supra* note 61, at 385 (criticizing that "the vast majority of small businesses have traditionally used flow-through entities, such as LLCs and S corporations, which are ineligible for the QSBS exclusion.").

77. *See, e.g.*, 2015 Legis. Bill Hist. US S.B. 973 (2022) (amending the Internal Revenue Code to "allow a new business-related tax credit for 25% of equity investments of $25,000 or more in a domestic corporation or partnership that: (1) has its headquarters in the United States, (2) has gross revenues for the taxable year of less than $1 million, (3) employs fewer than 25 full-time employees, (4) has been in existence for less than 7 years as of the date of the investment, (5) has more than 50% of its employees performing substantially all of their services in the United States, and (6) is engaged in a high technology trade or business. Limits the allowable amount of such credit to $250,000 in any taxable year and imposes an overall limitation on such credit of $500 million for each of calendar years 2015 through 2019.").

78. *See, e.g.*, Arizona Small Business Capital Investment Tax Credit, A.R.S. § 43-1022(27); Arkansas Equity Investment Tax Credit, A.C.A § 15-4-3301; Connecticut Angel Investor Tax Credit, Conn. Gen. Stat. § 12-704d; Colorado Innovation Investment Tax Credit, C.R.S. § 24-48.5-112; Georgia Angel Investment Tax Credit, O.C.G.A. § 48-7-40.30; Hawaii High Technology Business Investment Tax Credit, H.R.S. § 235-110.9; Illinois Angel Investment Tax Credit Program, 35 ILCS Art. 5/220; Indiana Venture Capital Investment Tax Credit, I.C. § 6-3.1-24; Iowa Innovation Fund Investment Tax Credit, Iowa Code § 15E.52; Kansas Angel Investment Tax Credit, K.S.A. § 74-8131–74-8137; Kentucky Investment Fund Tax Credit, K.R.S. § 154.20-250–.20-284; Louisiana Angel Investor Tax Credit Program, LA. STAT. ANN. § 47:6020; Maine Seed Capital Tax Credit, M.R.S. § 1100-T; Maryland Biotechnology Tax Credit, Md. Tax-General Code Ann. § 10-725; Massachusetts Angel Investor Tax Credit, M.G.L.A. 62 § 6(t); Minnesota Seed Capital Investment Credit, MINN. STAT. §§ 116J.8732, 290.06; Minnesota Small

are government-provided incentives aimed at stimulating investment in fledgling companies or small enterprises.[79] These credits are intended to incentivize angel investors, who provide financial support to entrepreneurs or small enterprises during their early phases of growth.[80] The objective is to cultivate innovation, stimulate economic expansion, and facilitate the creation of new jobs. These state tax benefits are designed to enhance the appeal of early-stage investments for private investors, who sometimes encounter elevated risks when allocating funds to start-up firms.[81] Local governments provide tax incentives with the goal of promoting more investment in businesses that are creative and have the potential for rapid growth. This, in turn, helps to foster the formation of a strong entrepreneurial environment.

Accredited investors have the opportunity to utilize income tax credits—mostly refundable—to reduce the amount of income tax that they are required to pay on their individual or corporation

Business Investment Tax Credit, MINN. STAT. § 116J.8737; Nebraska Angel Investment Tax Credit, N.R.S. § 77-6301; New Jersey Angel Investment Tax Credit, N.J.S.A. § 54:10A-5.28, N.J.S.A. § 54A:4-13; New Mexico Angel Investment Tax Credit, N.M.S. § 7-2-18.17; New York Qualified Emerging Technology Company (QETC), NY CLS Tax §§ 210.12-E, 606(r); North Dakota Seed Capital Investment Tax Credit, N.D. Cent. Code, § 57-38-34; Ohio InvestOhio Program, O.R.C. § 122.86; Oklahoma Small Business Capital Formation Incentive Act, 68 Okl. St. § 2357.60; Oklahoma Rural Venture Capital Formation Incentive Act, 68 O.S. § 2357.71–.102; Oregon University Venture Development Fund Tax Credit, O.R.S. § 315.321; Rhode Island Innovation Tax Credit, R.I. Gen. Laws § 44-63.1–.5; South Carolina High Growth Small Business Job Creation Act, S.C. Code 1976 § 11-44-40; Utah Venture Capital Enhancement Act, U.C.A. 1953 § 63N-6-101 et seq.; Vermont Angel Venture Capital Gain Deferral, 32 V.S.A. §§ 5930v, 5811(21)(B)(iii), 5811(21)(A)(iii); Virginia Qualified Equity and Subordinated Debt Investments Tax Credit, Va. Code §§ 58.1-203, 58.1-339.4; Wisconsin Angel Investor Tax Credit, Wis. Stat. § 238.15; *see* David D. Ebersole, *The Georgia Angel Investment Tax Credit and State Efforts to Fill the Funding Gap Through Tax Policy*, 30 J. TAX'N & REGUL. FIN. INST. 33, 33 n.1 (2017).

79. Jeffrey Williams, *Tax Credits and Government Incentives for Angel Investing in Various States* 1 (Angel Capital Ed. Foundation, July 2008), https://www.angelcapitalassociation.org/data/Documents/Public%20Policy/State/Tax%20Credits%20-%20Jeffrey%20Williams.pdf?rev=8C5D [https://perma.cc/SQ7A-3M8D].

80. *Id. See also* Sanjay Parekh, *The Problem With Georgia HB 1069 (Part 2)* (June 21, 2010), https://www.sanjayparekh.com/the-problem-with-georgia-hb-1069-part-2/ [https://perma.cc/E4U5-MSFZ].

81. *See* Nicholas J. Herdrich, Comment, *Wisconsin's Qualified New Business Venture Program: Building on the Foundation to Maximize Entrepreneurial Growth*, 2014 WIS. L. REV. 1031, 1033 (2014) (noting the Wisconsin New Venture Business Program's aim to incentivize early-stage investments in high-tech businesses through nonrefundable tax credits).

income.[82] The percentage of tax benefit provided by angel tax credits can vary widely depending on the jurisdiction and the specific regulations in place. Each government establishes its own rules regarding the amount and structure of the credit. In some cases, angel tax credits may cover a percentage of the investment made by an individual angel investor. For example, some jurisdictions might offer tax credits that equal a certain percentage (e.g., 20 or 25 percent) of the amount invested in qualifying startups. In most cases, it is a prerequisite for the state to provide an ex-ante certification that declares both the company and the investor are qualified to obtain the required credit. Only once the transaction has been finalized is the investor able to submit their application for the tax credit.[83] This necessitates a significant amount of cooperation between the company and the investor over a period of time that often spans several months.

Aside from angel tax credits, certain states offer other types of innovation tax incentives. Consider the following examples. Founded in 2010, the Colorado Innovation Investment Tax credit created a tax credit that was equivalent to a certain proportion of the investment, which could be used to offset state income tax obligations.[84] The tax credit for an equity investment in a qualifying small enterprise in the aerospace, biotech, renewable energy, or information technology field was allowed.[85] The Colorado Office of Economic Development had been mandated to assess eligibility for the tax credit and to provide nontransferable tax credit certificates as proof of eligibility and the specific amount of

82. *See, e.g.*, James R. Hardin & Thomas G. Noland, *Chapter 8: An Analysis of Angel Investment Tax Credits,* 60 GAS & ENERGY Q. 769, 773 (2012) ("Minnesota's tax credit program is refundable, meaning that qualified investors can get the credit even if they do not have a tax liability here. Qualified angel investors can receive a 25-cent tax credit for every dollar they invest in certified small businesses in Minnesota. The maximum credit for an individual investor is $125,000 per year, and the minimum investment needed to qualify for the credit is $10,000."). *But see* Ebersole, *supra* note 78,78 at 33 (noting that in Georgia the credit is nonrefundable, and the amount of the credit may not exceed the investor's Georgia income tax liability).

83. *See* Herdrich, *supra* note 81, at 1042 (discussing the process of certification requirements for early-stage businesses).

84. H.B. 09-1105, 67th Gen. Assemb., 1st Reg. Sess. (Colo. 2009).

85. *Advanced Industry Investment Tax Credit*, COLO. OFFICE ECON. DEV. & INT'L TRADE, https://oedit.colorado.gov/advanced-industries-investment-tax-credit [https://perma.cc/3QNW-DSZ3] (last visited Apr. 14, 2024) (explaining the credit is evenly spread over the two tax years after the investment, is limited to a maximum amount, is prohibited from being refunded but may be carried forward a specified number of years).

the tax credit.[86] Yet, the program was discontinued in 2011 and replaced with the Advanced Industry Investment Tax Credit, which specifically targets enterprise zones.[87]

Another illustration of state innovation benefits is one of utmost significance to the topic of crowdfunding. The only tax benefit in the U.S. that specifically targets investment crowdfunding can be found in the tax system of the state of Virginia.[88] The Qualifying Equity and Subordinated Debt Investments Tax Credit, enacted in 2013, offers an income tax credit of up to $50,000.[89] This benefit is equivalent to 50 percent of the qualifying investments made via online platforms such as general solicitations, online brokers, or crowdfunding portals.[90] The tax credit is provided to investors in a grant-like program. To be eligible for the credit, an investment in a qualified company must be supported by a qualified business certification from the Treasury Department for the corresponding calendar year.[91]

A qualifying business is defined as a business that meets the following criteria: It has generated annual gross revenues of not more than $3 million in its most recent fiscal year; its primary office or facility is located in Virginia; it engages largely in business operations or conducts the majority of its production activities in Virginia; it has not raised more than $3 million in total cash proceeds from the sale of its stocks or bonds (excluding loans from

86. *Id.* (requiring a taxpayer to submit a copy of the tax credit certificate in order to claim the tax credit. Requires the office and the department of revenue to share information related to the tax credits).

87. *Id.* ("Investors can earn a tax credit of 25% of their investment up to a maximum $100,000 credit on an investment of $10,000 or more. If the advanced industries business is in a Colorado enterprise zone or rural county, investors can earn a state income tax credit of 35% of their investment.").

88. *See* Craig M. Burns, Va. Tax Comm'r, *Guidelines Regarding Crowdfunding Investments That Qualify for Tax Credits*, (Oct. 3, 2016), https://www.tax.virginia.gov/laws-rules-decisions/rulings-tax-commissioner/16-193 [https://perma.cc/J657-G7YV] ("Currently, the Qualified Equity and Subordinated Debt Investments Tax Credit is the only Virginia tax credit that is directly based upon an equity investment made by the taxpayer.").

89. *Id.* In the 2013 Session, the Virginia General Assembly passed House Bill 1872 (2013 Acts of Assembly, Chapter 289), which permits taxpayers to receive income tax credits for any investments made through online general solicitations, online brokers, or funding portals aka "crowdfunding."

90. *Id.*

91. *Id.* In order to obtain such a qualified business certification, a company is required to submit a fully filled out Form QBA to the Department no later than December 31 of the corresponding calendar year in which it seeks certification. In order for investments in a company to be eligible for the credit, the business must annually file a new Form QBA and get a new certification as a qualified business.

banks or savings institutions); and it is mainly involved in industrial activities such as advanced computing, advanced materials, advanced manufacturing, agricultural technologies, biotechnology, electronic device technology, energy, environmental technology, information technology, medical device technology, nanotechnology, or any other similar technology-related field, as specified in regulations issued by the Virginia Department of Taxation.[92] The maximum limit for aggregate available tax credits is set at $5 million for Taxable Year 2014 and all subsequent years. The total tax credit that each taxpayer may claim cannot exceed the lower of the amount of tax they owe for that taxable year or $50,000.[93] Any tax credit that cannot be used in the first taxable year it was granted may be carried over for the subsequent fifteen consecutive taxable years or until the whole amount of the tax credit has been utilized, whichever comes first.[94]

After surveying the available federal and state tax incentives for investment in early stage and high growth ventures, the next Part will assess the hurdles in utilizing existing tax benefits in the context of crowdfunding. It will delve into the complications and potential pitfalls associated with investors channeling capital through crowdfunding mechanisms, shedding light on the regulatory, financial, and operational hurdles that can emerge for entrepreneurial ventures and their investors when navigating this evolving landscape.

III. REFLECTIONS ON THE USE OF TAX INCENTIVES IN THE CONTEXT OF INVESTMENT CROWDFUNDING

It is an important axiom that one has to consider the potential tax consequences before making an investment. Yet, when applying tax incentives within investment crowdfunding, greater complexity arises. Investors must ensure that the corporation-level criteria are met, particularly the gross assets test, qualifying trade or business criterion, and the production activity rule. For example, in order to

92. *Id.*

93. *Id.* Tax credits for commercialization investments are limited to 50 percent. If commercialization investment tax credits are less than half of the available amount, the rest is to be allocated to non-commercialization projects.

94. *Id.* If a taxpayer does not retain the equity from a qualified investment for at least three calendar years after the year a tax credit is assigned, they must surrender both the utilized and unused tax credits and pay the Department interest on the entire amount of tax credits granted starting from the date of allocation. The dissolution of the qualifying company that issued the shares, the merger, amalgamation, or other acquisition by a non-business entity, or the taxpayer's death are exceptions.

be eligible for any of the tax benefits in sections 1202, 1045, or 1244, it is necessary to own tangible ownership stakes, such as common or preferred shares.[95] Convertible securities, such as convertible notes or SAFEs, are not considered to represent ownership in a corporation and so do not qualify for these tax deductions until they have been converted into equity.[96] SAFEs are often used by platform businesses in several equity crowdfunding campaigns to simplify the financing process and organize the investment. Backers provide cash with the anticipation of turning their investment into ownership shares at a future point when the firm obtains more financing.[97] If the convertible security is converted into common or preferred stock that fulfills the criteria of QSBS, the five-year term for holding the stock commences on the conversion date.[98] International investors should carefully review the eligibility criteria of each Reg CF crowdfunding offer to see whether they are eligible to participate.[99]

Uncertainty arises in the context of tax credits crowdfunded in the U.K. as well as some of the state angel tax credit programs since both the business and the investor must get certification from most of the state programs to confirm their eligibility for the credit; however, this certification is only granted after the agreement has been finalized.[100] Following the conclusion of a crowdfunding campaign, the due diligence procedure begins. Investors and the

95. *See* Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137, 141 (2003) ("If identifying these biases prevents rigorously testing rational explanations, we may sometimes miss the subtle yet important details that can help account for the behavior of sophisticated actors in a complex marketplace.").

96. *Id.* at 179 ("[s]o long as the entire IPO process—from the exchange of partnership interests for convertible preferred stock followed by conversion to common followed by sale to the public—was contemplated and outlined in the original documents, the SEC rule should not prove to be too high a hurdle for selling shareholders.").

97. *See* SCHWARTZ, *supra* note 10, at 132 ("The SAFE holders then receive common stock at the same valuation as the later investors. Depending on the terms of the SAFE, the holders may receive a valuation that is even more attractive than the later investors receive; this can be accomplished in several ways, most simply by promising SAFE holders a specified percentage discount on the ultimate price of the common stock. The SAFE became rather popular in the American crowdfunding marketplace during the first few years of crowdfunding.").

98. 26 U.S.C. § 1202 (1993). Stock obtained exclusively via the conversion of QSBS in a recapitalization transaction is considered to be QSBS and retains the original holding term.

99. *See* Brian, *Three Ways the U.S. Gives Tax Relief for Investing in Startups,* CROWDWISE (Mar. 19, 2020), https://crowdwise.org/taxes/three-ways-the-us-gives-tax-relief-for-investing-in-startups/ [https://perma.cc/9SRS-MDY8].

100. *But see* Steinhoff, *supra* note 20, at 693 (noting an investor may self-certify by signing "Self-Certified Sophisticated Investor" statement).

business conduct a comprehensive analysis of each other's finances, operations, and legal status. This procedure is essential for investors to evaluate the feasibility of the investment and for the firm to verify that the investor is in line with its strategic objectives. This necessitates significant collaboration between the company and the investor, usually spanning many months after the crowdfunding campaign has concluded. The partnership between a firm and its angel investors extends beyond the crowdfunding campaign and continues as a dynamic and continuous activity. Prolonged collaboration is essential for effectively negotiating the intricacies of angel investments and fulfilling the criteria of angel tax credit schemes. Effective communication, establishment of trust, and a mutual commitment to the firm's success are essential components in cultivating a fruitful and long-lasting relationship between the company and its angel investors.

Tax salience is also a major issue in the context of investment crowdfunding tax incentives.[101] The dynamic and rapidly changing nature of the start-up environment, together with a strong emphasis on product development, market expansion, and overall company expansion, may cause entrepreneurs and their investors to neglect tax-related issues. Start-ups face considerable obstacles due to the widespread lack of attention paid to tax issues until they arise.[102] Entrepreneurs and investors may place more importance on addressing current company requirements rather than focusing on long-term tax strategies. The company's narrow emphasis on short-term goals may result in overlooking chances for tax optimization, such as using existing credits and incentives, which might have a substantial positive impact on the company's financial performance. Moreover, a substantial agency problem arises when small investors lack sufficient control over crowdfunding organizations to compel compliance with the essential requirements of different tax rules that may provide them with benefits.[103]

101. *See* Fleischer, *supra* note 95, at 184 ("It is not surprising, then, to see that entrepreneurs and venture capitalists stick with the devil they know.").

102. *See id.* at 139 ("[I]t is a mistake to conclude that start-ups are organized irrationally, or to accept the conventional wisdom that a casino mentality or some other cognitive bias explains the behavior of deal planners.").

103. *See, e.g.*, Joseph J. Dehner & Jin Kong, *Twenty-Seventh Annual Corporate Law: Symposium: Crowdfunding Regulation and Their Implications: Equity-Based Crowdfunding Outside the USA*, 83 U. CIN. L. REV. 413, 440 (2014) ("Risks to expanding the availability of EBCI platforms include fraud and abuse, high failure rate of startup ventures, illiquidity of investments, lack of adequate due diligence, valuation of equity offered, future dilution problems, and control issues for startup ventures.").

To tackle some of those issues and encourage use of crowdfunding mechanisms to raise seed capital in the U.S., the Treasury Department ("Treasury") should establish safe harbor regulations specifically for crowdfunding investors. These regulations should ensure that taxpayers may easily comply with the necessary guidelines and have peace of mind knowing that their crowdfunding investments will be eligible for tax benefits, such as exempting capital gain, allowing them to claim ordinary losses, and rolling over their basis to their next qualified investment. Treasury must promulgate regulations that clearly define the criteria for determining whether crowdfunding revenues should be classified as excluded from gross income or reported as taxable income.

The Internal Revenue Service ("IRS") needs to implement unambiguous directives about tax benefits for investment crowdfunding. A year ago, the IRS released instructions specifically addressing the tax implications of crowdfunding in general, with a particular emphasis on gift and nontaxable donations.[104] The IRS should create comparable safe harbor rules for investment crowdfunding, enabling taxpayers to adhere to simple guidelines and have the assurance that their crowdfunding investments would benefit from the currently available tax preferences that encourage seed-capital and high-growth ventures. Establishing clear guidelines for investment crowdfunding will alleviate the distinct obstacles and intricacies linked to crowdfunding as an emerging type of financing. A safe harbor might facilitate the development and advancement of the investment crowdfunding funding mechanism by promoting transparency, fostering engagement, and lessening regulatory costs. This approach would align with the regulatory objectives of promoting innovation and broadening access to capital.

Clearly, when it comes to investment tax incentives, especially those involving intricate small business rules, it is essential to increase salience and stay up to date since these regulations are very susceptible to change. Furthermore, many restrictions that apply to the size of the firm or its industry are subject to yearly updates, and new tax legislation may complicate things further. To reduce agency and administrative costs for investors and the IRS, it is also advisable that crowdfunding companies and

104. *See Some Things to Know About Crowdfunding and Taxes*, INTERNAL REVENUE SERV. (Aug. 8, 2022), https://www.irs.gov/newsroom/some-things-to-know-about-crowdfunding-and-taxes [https://perma.cc/JD9B-EUPV].

crowdfunding platforms provide advance tax assurances.[105] This can be done through the issuance of representations and statements (with a legal disclaimer regarding their tax advice authority) or by obtaining a private letter ruling from the IRS.[106] Such statements of compliance might even mirror those mandated to be issued for the U.K.'s SEIS scheme, or even Colorado's tax incentive program discussed earlier.[107] These measures would demonstrate the company's compliance with tax requirements of qualified small business stock investment tax benefits and clarify the tax implications of specific crowdfunding rounds for potential investors prior to their investment.

The tax consequences for new enterprises are typically overlooked in favor of short-term operational issues, yet they provide significant opportunities for savvy investors that are aware of them. Businesses of all sizes seeking optimum fiscal strategies must have a critical awareness of the dynamic and diverse ramifications, especially in the field of investment crowdfunding. Such benefits should not be tied to the small business tax benefits but tailored to investment crowdfunding's flexible and rapid nature. The regulations governing investment crowdsourcing should be specifically designed to promote innovation via such investment methods, while ensuring that crowdfund participants feel confident and have a clear understanding of the tax consequences.

105. *See, e.g.*, Mirit Eyal-Cohen, *Preventive Tax Policy: Chief Justice Roger J. Traynor's Tax Philosophy*, 59 HASTINGS L. J. 877, 896 (2008) (discussing the historical background of private rulings and ways taxpayers and tax authorities can reduce tax adjudication).

106. *See, e.g.*, *Short Takes: Recent Developments of Interest to Investors*, 34 J. TAX'N INV. 67, 74 (2017) (discussing the possibility of seeking a private letter ruling on treating a particular crowdfunding transaction as a gift).

107. *See Tax Relief for Investors Using Venture Capital Scheme*, *supra* note 24 and accompanying text.