

Crowdfunding: Rules of the Game in a Changing Landscape¹ *Gene Takagi²*

Crowdfunding is defined as “the practice of funding a project or venture by raising many small amounts of money from a large number of people (the “crowd”), typically via the Internet.”³

An estimated \$16.2 billion was raised globally through crowdfunding in 2014⁴, and that number has been projected to reach \$34.4 billion in 2015⁵. According to a 2013 study commissioned by the World Bank, crowdfunding is projected to become a \$90-96 billion dollar industry by 2025⁶, almost twice the size of the global venture capital industry today⁷.

Forms of Crowdfunding

While there are several ways of categorizing crowdfunding, the most common forms are commonly referenced as donation crowdfunding, rewards crowdfunding, and investment crowdfunding.

- Donation crowdfunding involves asking the *crowd* for a gift.
- Rewards crowdfunding involves the promise of a return benefit to the crowd.
- Investment crowdfunding involves the selling of equity (e.g., stock) or debt (e.g., note promising a rate of interest).

Nonprofits and Crowdfunding

Nonprofits⁸ that use crowdfunding most commonly do so as a form of fundraising. Often, they will provide a reward to help induce a donation, but the value of the

¹ The general focus of this article is on crowdfunding by nonprofit organizations exempt under Section 501(c)(3) of the Internal Revenue Code and described as public charities. Its author has used reasonable efforts in collecting, preparing, and providing this information but does not guarantee its accuracy, completeness, adequacy, or currency. This article does not constitute legal or professional advice. Its publication and distribution are not intended to create, and its receipt does not constitute, an attorney-client relationship. If specific legal advice is sought, the reader is advised to retain the services of a competent professional in the appropriate jurisdiction.

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³ http://www.oxforddictionaries.com/us/definition/american_english/crowdfunding.

⁴ <http://www.crowdsourcing.org/editorial/global-crowdfunding-market-to-reach-344b-in-2015-predicts-massolutions-2015cf-industry-report/45376>.

⁵ *Id.*

⁶ <http://www.infodev.org/crowdfunding>.

⁷ See <http://fortune.com/2014/04/17/why-investors-are-pouring-millions-into-crowdfunding/>.

⁸ For purposes of this article, “nonprofits” shall generally refer to nonprofit organizations that are tax-exempt under Section 501(c)(3) of the Internal Revenue Code and described as a public charity.

reward will not exceed the amount of the donation. This will help ensure that at least part of the donor's payment will be eligible for a charitable contribution deduction.

Nonprofits may also be able to engage in investment crowdfunding but because they generally have no ownership structure (and therefore no equity), this would be limited to debt crowdfunding. In contrast, a nonprofit's for-profit subsidiary or joint venture may be able to engage in equity crowdfunding.

Nonprofits experienced with fundraising may question whether donation crowdfunding significantly differs from more traditional forms of fundraising. Donation crowdfunding typically is project-focused and time-limited and targets a broader group of prospective donors who are more interested in the project than the organization. While there remains an absence of laws specifically regulating donation crowdfunding, the focus of such campaigns raises several legal issues of which crowdfunding nonprofits should be aware.

Charitable Registration

Generally, nonprofits soliciting charitable contributions must comply with state laws, including any charitable registration requirements, in the states in which they are making such solicitations. Currently, about 39 states and the District of Columbia (DC) require registration and some of the remaining states may require a certificate of authority. 36 states and DC will accept the Uniform Registration Statement (URS), but that still requires an organization to file the URS with each state's charity official (typically the Attorney General) and, in 13 jurisdictions, specific supplemental forms.

Generally, for a state to exercise jurisdiction over an online solicitor, the solicitor must have minimum contacts with such state so as not to offend traditional notions of fair play and justice.⁹ Minimum contacts refer not only to the number of contacts, but also to their nature and quality.¹⁰ In addition, there must be a sufficiently close nexus between the minimum contacts and the lawsuit.¹¹

Online solicitations inherently do not operate within state boundaries and have caused great confusion regarding state registration requirements. In the *Zippo* case, the federal district court suggested that a passive website simply posting information would not be sufficient to justify jurisdiction but that a website actively concluding business transactions would be.¹² In between those two ends of the *Zippo* sliding scale, the court said that "the exercise of jurisdiction is determined by

⁹ See *International Shoe v. Washington*, 326 US 310, 316 (1945).

¹⁰ See *Zippo Mfg. Co. v. Zippo Dot Com*, 952 F. Supp. 1119, 1124 (W.D. Pa. 1997).

¹¹ See *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 475-76 (1985).

¹² See *Zippo*, 952 F. Supp. at 1124.

examining the level of interactivity and commercial nature of the exchange of information that occurs on the Web site.”¹³

In recognition of the complexity of the jurisdictional issues and online fundraising, the National Association of State Charity Officials (“NASCO”) approved the Charleston Principles in 2001 as nonbinding advisory guidance. Under the Charleston Principles, a nonprofit would be required to register for online charitable solicitations if the nonprofit solicits donations through an interactive website; and the nonprofit either: (i) specifically targets persons located in the subject state for solicitation; or (ii) receives contributions from the state on a repeated and ongoing basis or a substantial basis through its website.¹⁴ In addition, registration would be required if the nonprofit solicits donations through a site that is not interactive if it meets one of the conditions above and either specifically invites further offline activity to complete a contribution, or establishes other contacts with that state, such as sending e-mails or other communications that promote the website.¹⁵

While the Charleston Principles offer helpful guidance, they still leave up to individual states to interpret what is meant by “a repeated and ongoing basis” and “a substantial basis.” Yet only Tennessee¹⁶ and Colorado¹⁷ have incorporated and defined these thresholds in their state laws. The laws regarding personal jurisdiction and the Charleston Principles have yet to catch up to our rapidly evolving technologies and new ways for parties to interact,¹⁸ but the development of such laws may require more jurisprudence on the underlying minimum contacts issue regardless of the technology involved.

A Delaware nonprofit, The Multistate Registration and Filing Portal, Inc. (“MFRP”), working with NASCO and the National Association of Attorneys General (NAAG), is developing an online system that will allow nonprofit organizations and their professional fundraisers to comply with all states’ registration and annual filing requirements through a single portal. There are 13 pilot states participating in the portal’s initial development. The latest entry on the MFRP blog states that an announcement regarding the selected vendor to build the portal will be made after final decisions and contract negotiations are complete.¹⁹

¹³ *See id.*

¹⁴ *See* <http://www.nasconet.org/wp-content/uploads/2011/05/Charleston-Principles-Final.pdf>.

¹⁵ *See id.*

¹⁶ 100 online contributions or \$25,000 in online contributions in a year.

¹⁷ 50 online contributions or \$25,000 in online contributions in a year or 1 percent of their total contributions for the year.

¹⁸ *See* Alan M. Trammell and Derek E. Bambauer, Personal Jurisdiction and the “Interwebs”, 100 *Cornell L. Rev.* 1129 (2015).

¹⁹ <http://mrfpinc.org/blog/continued-progress-towards-a-single-portal.html>

Professional / Commercial Fundraisers

A professional or commercial fundraiser for charitable purposes may be defined and regulated under state law. In the states where such fundraisers are required to register, nonprofits may be required to enter into contracts only with those professional or commercial fundraisers are properly registered. Further, nonprofits must generally establish and exercise control over fundraising activities conducted for their benefit. This obligation includes approving all written contracts and agreements, and assuring fundraising activities are conducted without fraud or coercion.

In California, a commercial fundraiser is defined as any individual, corporation, or other legal entity that for compensation does any of the following:

- Solicits funds, assets, or property in California for charitable purposes.
- As a result of a solicitation of funds, assets, or property in California for charitable purposes, receives or controls the funds, assets, or property solicited for charitable purposes.
- Employs, procures, or engages any compensated person to solicit, receive, or controls funds, assets, or property for charitable purposes.²⁰

While crowdfunding operators, such as Indiegogo (Generosity), do receive compensation for hosting campaigns on their websites, several do not appear to actually solicit funds (request gifts or money) on behalf on the charity. Instead, the actual content of the campaign is controlled by the campaign creator. The crowdfunding operator does not actively solicit individuals to donate to campaigns on its website, but instead it provides an online platform where potential contributors (or donors) can review and select from hundreds of different campaigns for both charities and for-profit entities.

In addition, these crowdfunding platforms generally do not themselves, and do not through compensated persons, actually receive or control the funds solicited by individuals or organizations for charitable purposes. The funds raised on Indiegogo are processed through PayPal and are disbursed to campaign owners once the campaign is completed.

Many crowdfunding operators appear to be aware of the potential confusion as to whether they fall under states' charitable solicitation laws, including the California commercial fundraiser statute. On its website, GoFundMe includes the following statement in its terms and conditions:

²⁰ Cal. Gov. Code §12599(a).

The Services are a Platform; We are not a Broker, Financial Institution, Creditor or Charitable Institution: The Services are an administrative platform only. GoFundMe facilitates the Donation transaction between Campaign Organizers and Donors, but is not a party to any agreement between a Campaign Organizer and a Donor, or between any user and a Charity. GoFundMe is not a broker, agent, financial institution, creditor or insurer for any user. GoFundMe has no control over the conduct of, or any information provided by a Campaign Organizer or a Charity, and GoFundMe hereby disclaims all liability in this regard.²¹

The Charleston Principles provide an exemption to the registration requirements for “entities that provide solely administrative, supportive or technical services to charities without providing substantive content, or advice concerning substantive content”. However, if these service providers do more than simply provide technical services and actually solicit or promote a website, then registration may be required. Compensation for services based on the amount of funds raised may be a strong indication the entity is doing more than simply providing technical services. If these Principles were binding, one could argue that sites that charge fees based on the amount of funds raised may be required to register with the state. However, as discussed earlier, the law has not adequately addressed the minimum contacts jurisdictional issues and not caught up with the technology.

Governing Documents

A nonprofit must be operated consistent with its specific purpose statement in its governing documents. If, for example, a nonprofit’s articles of incorporation provide for a charitable purpose limited to delivering afterschool services in Los Angeles, the nonprofit may not, without appropriately amending its articles, engage in crowdfunding to build a library in San Diego. Such activity would be considered *ultra vires* or beyond the corporation’s authority.

501(c)(3) Organizational and Operational Tests

An organization exempt under Section 501(c)(3) of the Internal Revenue Code must be organized and operated exclusively for one or more exempt purposes set forth in Section 501(c)(3).²² The *Organization Test* is satisfied if the organization’s governing documents meet certain requirements, including limiting the organization’s purpose and irrevocably dedicating its assets to one or more exempt purposes.²³ The

²¹ <https://www.gofundme.com/terms>.

²² Treas. Reg. §1.501(c)(3)-1(a).

²³ Treas. Reg. §1.501(c)(3)-1(b).

Operational Test is satisfied if the organization is operated primarily for such exempt purposes.²⁴

No Private Benefit / Charitable Class

In order to meet the Operational Test, a 501(c)(3) organization must serve a public rather than a private interest.²⁵ To satisfy this requirement, referred to as the private benefit doctrine, the nonprofit must establish that it is not operated for the benefit of private interests. This does not mean that the nonprofit may not confer benefits to individuals; rather, it provides that such benefits must be incidental, quantitatively and qualitatively, to the furthering of the nonprofit's exempt purposes.²⁶ The nonprofit may, of course, provide benefits to a charitable class in furtherance of its exempt purposes. According to the IRS, "[a] charitable class must be large enough or sufficiently indefinite that the community as a whole, rather than a pre-selected group of people, benefits when a charity provides assistance."²⁷ Accordingly, a nonprofit whose operations are focused only on benefiting a small, finite number of individuals may be operating inconsistent with its 501(c)(3) status.

Conduit Issues

Qualified organizations eligible to receive deductible charitable contributions²⁸ are described under Section 170(c) of the Internal Revenue Code. It should be noted that the charitable organizations referenced in Section 170(c) are not identical to their counterparts in Section 501(c)(3). Importantly, Section 170 does not provide for deductible charitable contributions to foreign organizations and public safety organizations, even if such organizations are tax-exempt under Section 501(c)(3).

Nonprofits described as qualified organizations under Section 170(c) raising funds on a crowdfunding site cannot provide that the donor's contributions are eligible for a charitable contribution deduction if the nonprofit acts merely as a conduit for funds to go to a specific individual or to a taxable or foreign entity.²⁹ In such case,

²⁴ Treas. Reg. §1.501(c)(3)-1(c).

²⁵ Treas. Reg. §1.501(c)(3)-1(d)(1)(ii).

²⁶ Gen. Couns. Mem. 39862, Nov. 21, 1991.

²⁷ IRS Publication 3833 (Rev. 12-2014).

²⁸ The authorizing provision for the charitable contribution deduction is IRC §170(a), which provides in pertinent part: "There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year."

²⁹ See, e.g., *Davis v. United States*, 495 U.S. 472 (1990) (holding that "funds transferred by the taxpayers to their two sons while they served as full-time, unpaid missionaries of the Church of Jesus Christ of Latter-day Saints (Church) did not qualify as a charitable contribution made "for the use of" the Church in absence of evidence that funds were transferred "in trust for" the Church); *Graves v. Commissioner*, T.C.M. 1994-616 (holding that "amounts paid by the taxpayers to the Owl Foundation, which in turn paid their childrens' [sic] tuition to educational institutions, were not contributions within the meaning of IRC 170(c)").

the donor has in substance made a contribution to a nonqualified recipient. Accordingly, a crowdfunding nonprofit should not permit donors to direct their donations to a particular individual or other entity. In contrast, the nonprofit may be able to feature an example of one of its own targeted beneficiaries but represent to prospective donors that it retains the right to expend the contributions as it sees fit, subject to complying with its own representations in the solicitation.

Rewards Crowdfunding

Rewards crowdfunding involves the promise of some return benefit to the donor in exchange for a payment to benefit the project. If the payment is made to a 501(c)(3) organization, the reward may require the payment to be characterized in part as a charitable contribution and in part as a sale. Such transactions may fall within the definition of a *quid pro quo* contribution, triggering certain substantiation requirements for the organization. Moreover, sellers permit, sales tax, and unrelated business income tax issues may also be implicated.

Substantiation of Donations

To substantiate a deduction for contributions *of any amount*, a taxpayer must maintain a bank record or a written communication from the charity showing the name of the organization, the date of the contribution, and the amount of the contribution.³⁰ For a charitable contribution made by payroll deduction, a pay stub, Form W-2, or other employer-furnished document that sets forth the amount withheld for payment to the organization, along with a pledge card prepared by or at the direction of the donee organization, will be deemed to be a "written communication from the donee organization" that satisfies the requirements (see below for information about payroll deductions of \$250 or more).

Additional substantiation requirements remain in effect for contributions of \$250 or more. For any contribution of \$250 or more, in order for a donor to be able to claim a charitable deduction, the donor must receive a written acknowledgment of the contribution from the nonprofit which includes the amount of cash and a description (but not the estimated value) of any property other than cash contributed; a statement whether the organization provided any goods or services in consideration for the contribution; and a description and good faith estimate of the value of any goods or services provided in consideration for the contribution, or, if the goods or services consist solely of intangible religious benefits, a statement to that effect.³¹ This acknowledgment from the charity must be "contemporaneous" - obtained by the donor *no later than the date the donor actually files a tax return for*

³⁰ Treas. Reg. §1.170A-13.

³¹ IRC §170(f)(8).

*the year in which the donation was made.*³²

In addition to the requirements for documenting cash contributions described above, when a nonprofit provides a good or service in exchange for a payment of more than \$75, the nonprofit must provide a written disclosure to the donor setting out the fair market value of the goods and services received, and informing the donor that only the portion of the contribution that exceeds this fair market value is tax deductible.³³ Such payments are referred to as *quid pro quo* contributions that are made partly as a contribution and partly in consideration for goods or services provided to the payor by the nonprofit.³⁴ Crowdfunding nonprofits that provide rewards as part of their campaigns may be soliciting *quid pro quo* contributions.

There is no written disclosure required when the goods or services given to a donor meet the standards for insubstantial value.³⁵ In 2016, goods and services are considered insubstantial if the payment occurs in the context of a fundraising campaign in which a nonprofit informs the donor of the amount of the contribution that is deductible, and either

- the fair market value of the benefits received does not exceed the lesser of 2% of the payment of \$107, or
- the payment is at least \$53.50, the only item provided bears the organization's name or logo (e.g., calendar, mug) and the cost of these items is below the limit of \$10.70.³⁶

If the written disclosure is required:

A good faith estimate of the value of goods or services provided by an organization described in section 170(c) in consideration for a taxpayer's payment to that organization is an estimate of the fair market value, within the meaning of § 1.170A-1(c)(2), of the goods or services. The organization may use any reasonable methodology in making a good faith estimate, provided it applies the methodology in good faith. A good faith estimate of the value of goods or services that are not generally available in a commercial transaction may be determined by reference to the fair market value of similar or comparable goods or services. Goods or services may be similar or comparable even though they do not have the unique qualities of

³² IRC §170(f)(8)(C).

³³ IRC §6115(a).

³⁴ IRC §6115(b).

³⁵ Treas. Reg. §1.170A-13(f)(8).

³⁶ These dollar amounts are adjusted each year for inflation; the 2017 amounts are set forth in Rev. Proc. 2016-55.

the goods or services that are being valued.³⁷

Seller's Permit and Sales Tax

If a reward crowdfunding campaign is soliciting *quid pro quo* contributions, the part of the transaction that is considered a sale rather than a charitable contribution may trigger for the nonprofit state requirements for a seller's permit and remittance of sales tax.

Accordingly, in a state that charges a 10% sales tax, if a nonprofit solicits a payment of \$100 that provides the donor with an item worth \$20, the transaction may trigger a \$2 sales tax. In such case, the amount of the charitable contribution will be \$78.

The vast majority of states have authorized a sales tax.³⁸ Whether an organization that is engaged in a sale on a crowdfunding site must collect and remit a sales or use tax from a particular state depends on whether the state has appropriate jurisdiction. For a state to have jurisdiction over an out-of-state seller, the seller's activities must have a *substantial nexus* with the taxing state as required under the Commerce Clause.³⁹ According to the American Institute of CPAs publication *The Tax Advisor*:

As states continue to grapple with the growing e-commerce industry, as of this writing, approximately 15 states have enacted "click-through nexus" provisions to expand their reach to certain out-of-state sellers. These provisions generally create presumptions of nexus if the out-of-state seller pays a commission to an in-state person who, through an internet link or otherwise, refers customers to the out-of-state seller, if the referral results in a sale and the seller's annual sales from the referrals reach a certain dollar threshold. Since the crowdfunding moderator is receiving a fee for providing an internet link for contributors to make contributions, these click-through nexus provisions may create nexus for the project initiator if the moderator has substantial nexus in a click-through nexus state.⁴⁰

Assuming that a state has jurisdiction to require the collection and remittance of sales taxes, the next issue is timing. When should the sales tax be reported? Treatment of this issue may vary among the different types of campaigns (e.g., sale

³⁷ Treas. Reg. §1.6115-1(a).

³⁸ Among the states that have not authorized a sales tax are Alaska, Delaware, Montana, New Hampshire, and Oregon.

³⁹ See *Quill v. North Dakota*, 504 U.S. 298 (1992).

⁴⁰ Justin Gruba, Lindsay McAfee, and Bradley H. Ashby, "Crowdfunding Contributions and State Sales and Use Taxes," *The Tax Advisor* (May 31, 2015), available at: <http://www.thetaxadviser.com/issues/2015/jun/tax-clinic-08.html>.

transaction completed immediately or upon reaching a funding goal) and among the states.

Unrelated Business Income Tax

If the reward crowdfunding campaign involves a sale of an item, and such sale is not in furtherance of the nonprofit's exempt purpose, the sale may also have unrelated business income tax ("UBIT") consequences for the nonprofit.

Related vs. Unrelated Business Income

From a federal tax perspective, earned income of nonprofits is categorized as either related or unrelated income. Unrelated income (after deducting expenses directly connected to the business producing the unrelated income) may be subject to UBIT, at rates equivalent to for-profit tax rates, which should be factored into the business plan. Moreover, and more fundamentally, under the commerciality doctrine, a court-created derivative of the operational test⁴¹, an exempt organization cannot engage in a substantial amount of unrelated business activity without risking the loss of its 501(c)(3) tax-exempt status.⁴² While some advisors use a general rule of thumb that generating less than 20 percent of an organization's gross income from unrelated business activities is likely permissible, there is no exact amount or percentage of business activity that constitutes a "substantial amount." In determining whether the substantiality limit has been crossed, it is more important to consider the percentage of organizational resources (*e.g.*, assets, staff hours) that are devoted to the unrelated business activity.

To be considered unrelated business income, the income must be generated by an activity that constitutes (1) a trade or business, (2) that is regularly carried on, and (3) is not substantially related to the furtherance of the organization's exempt purpose.⁴³ Whether an activity is a *trade or business* turns on whether it is carried on for the production of income from selling goods or performing services, and is conducted with a profit motive. An activity is *regularly carried on* if conducted with similar frequency and continuity with which a for-profit conducts the same activity. This means that a one-time fundraising event, such as a car wash or a charity auction, if not regularly carried on, will not generate unrelated business income. Finally, the revenues will only be subject to UBIT if the business activity is *not*

⁴¹ Treas. Reg. §1.501(c)(3)-1(c)(1) ("An organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.")

⁴² See W. Marshall Sanders, "The Commerciality Doctrine Is Alive and Well," *Taxation of Exempts* (March/April 2005): 209, 211.

⁴³ IRC § 513. See also IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, available at: <http://www.irs.gov/pub/irs-pdf/p598.pdf>.

substantially related to the organization’s exempt purpose. This third factor is often the most difficult factor to analyze and involves a highly fact-sensitive inquiry. To be substantially related, the activity must contribute importantly to accomplishing the organization’s exempt purpose other than through the production of income, and whether the generated income is used to fund charitable programs is irrelevant to the determination.⁴⁴ This prohibition on looking to the manner in which generated income is spent reinforces the underlying rationale of UBIT—to prevent tax-exempt organizations from having an unfair competitive advantage over for-profit entities engaging in the same business activity.⁴⁵

Exceptions to Unrelated Business Income

Federal law provides multiple exceptions for activities that may otherwise be considered to generate unrelated business income subject to taxation. Some of the more common of these exceptions include income generated from business activities for which substantially all of the work is performed by volunteers; a business carried on primarily for the convenience of an organization’s members, students, patients, officers, or employees; a business selling merchandise if substantially all of the merchandise has been donated to the organization; and the distribution of low-cost items as part of charitable fundraising efforts.⁴⁶ Another exception applies to qualified sponsorship payments made to an exempt organization if there is no arrangement or expectation that the payor will receive any return benefit in connection with the payment. Although benefits such as goods or services of an insubstantial value or use of the donor’s name or logo are acceptable, sponsorship payments differ from advertising (which is not excepted from UBIT) in that any such acknowledgment of the payor must include only value-neutral descriptions of products or services and the content should be controlled by the organization rather than the payor. There are also exceptions from UBIT that generally apply to certain forms of passive income, including real property rental income; interests, dividends, and annuities; royalty payments; and certain capital gains from the sale of property.⁴⁷

Peer-to-Peer Fundraising

Peer-to-peer fundraising (“P2P”) is a strategy in which a nonprofit enlists the help of its supporters to fundraise on the organization’s behalf. In the crowdfunding context, P2P generally involves individual campaign pages directed at each supporter’s social network and is more than just an informal verbal request made to

⁴⁴ Treas. Reg. 1.513-1(d)(2).

⁴⁵ Gene Takagi and Tony Wang, “Fair or Foul? A Review of Federal Tax Laws Governing Unfair Competition,” *The Nonprofit Quarterly*, Vol. 21, Issue 3 (Fall 2014): 50, 52-54.

⁴⁶ IRC § 513(a), (h).

⁴⁷ IRC § 512(b).

families and friends. According to Network for Good, P2P comprises 24 percent of online giving.⁴⁸

Delegated Authority

Nonprofit boards and managers may delegate authority and responsibilities to other agents of the nonprofit but should exercise reasonable care in selecting such agents, limiting the scope of delegated authority, and providing oversight. If unauthorized individuals are acting in the name of a nonprofit, the nonprofit should generally seek to stop such actions. Otherwise, the nonprofit may face exposure to liability and/or reputational harm. This may be particularly relevant in the case of crowdfunding, including peer-to-peer campaigns which allow for individuals to solicit charitable contributions using their own materials and events.

'Charitable' Crowdfunding By Non-Charities

Because nonprofits must be organized and operated to benefit a charitable class instead of a particular individual or small group of individuals, personal crowdfunding run by individuals has been a popular alternative to nonprofit crowdfunding. Personal crowdfunding can be very effective in providing immediate and direct assistance to a person or specific family or entity in need after an event. However, as opposed to campaigns run by charities that are heavily regulated to protect donors from fraud and ensure transparency, individual-run campaigns can be created for any lawful purpose, including for purely selfish reasons, and the resulting funds may be used without public disclosure.

One often misunderstood, and sometimes misrepresented, point is that donors do not benefit from a charitable contribution deduction when donating to an individual, even if for a charitable purpose.

Moreover, donors to individual campaigns may never be able to check whether their donations were used for their intended purpose the way they may if their donations had gone to a charity with public reporting requirements. Many crowdfunding operators do not verify the authenticity of the solicitation and, unlike charities, they do not oversee the use of funds raised. Accordingly, it can be easy to fraudulently raise funds for what appears to be a charitable purpose with no external oversight.

In response, some crowdfunding operators have created vetting and verification procedures to signal to donors that a qualified charity is running and/or overseeing a particular charitable campaign. Indiegogo/Generosity, for example, has a Trust and Safety team that verifies the legitimacy of campaigns, as well as a proprietary fraud algorithm that reportedly alerts the company to any suspicious activity. However, what remains unclear is whether nonprofits can and will stop

⁴⁸ <http://www.networkforgood.com/digitalgivingindex/>.

unauthorized personal crowdfunding campaigns explicitly operating for, or purportedly for, the nonprofit's benefit.

While personal crowdfunding can be effective when the campaign clearly states who its creator is (and whether it is attached to a charity that is supervising the campaign) and whether donors can receive a charitable contribution deduction, many campaigns are not so transparent.

Content Issues

The content included in a crowdfunding communication raises many issues, including whether (1) the solicitation is for a specific project that quite possibly leads to the receipt of restricted gifts, (2) the representations made are true and not misleading, (3) the content infringes on another person's intellectual property rights, (4) rights to the content need to be protected, (5) any regulated messages (e.g., lobbying) are included, (6) any prohibited communications are included (e.g., political campaign intervention, defamatory statements, breach of confidential or other protected information). It therefore makes great sense to have policies to impose some control over the content, including who may create content, what it may and may not include, and who may publish it.

Restricted Gifts

A restricted gift is one that can be used only for a particular purpose, in a particular geographic area, and/or within a particular time frame. For example, a donor can place restrictions that require the gift to be used for a particular program or to not be used on overhead expenses. When a nonprofit accepts a restricted gift, it accepts the donor's restriction and must honor that restriction. Similarly, if a nonprofit promises in its crowdfunding campaign to use a gift for a particular purpose, and the organization uses the gift for other purposes, such misrepresentation may be a violation of charitable trust principles and potentially fraud.

Fraud

Nonprofits and their agents are prohibited from misrepresenting the purpose of the charitable organization or the nature or purpose or beneficiary of a solicitation. Misrepresentation may be established by word, by conduct, or by failure to disclose a material fact. Nonprofits and their agents are also prohibited from engaging in fraud or using any deceptive practice that creates a likelihood of confusion or misunderstanding.

Generally, the state's attorney general may have the authority to file a lawsuit against a nonprofit or its agent (including any professional or commercial fundraiser) that engages in misrepresentations or fraud while soliciting for

charitable purposes. In 2015, Washington State Attorney General Bob Ferguson won a consumer action lawsuit over a project by an individual and his company that failed to deliver a promised horror-themed decks of cards to individuals who crowdfunded his project on Kickstarter.⁴⁹ Although this lawsuit was not against a nonprofit or commercial fundraiser, it does show that state lawmakers are paying attention to crowdfunding activities and are willing to bring suit against defrauders.

Nonprofits also should be aware that individuals may engage in unauthorized or fraudulent crowdfunding campaigns using the nonprofit's name. While state consumer protection laws may to some extent protect against such fraud, nonprofits should be diligent in reviewing any campaigns made in their name. Some crowdfunding operators provide for a verification symbol to be placed on the campaign page to certify to contributors that funds will go directly to a verified nonprofit aware of such campaign. To avoid fraud and misrepresentations, a nonprofit should provide clear guidance to all of its agents who will be running a crowdfunding campaign for the nonprofit's benefit.

Intellectual Property

A nonprofit is not immune from lawsuits for copyright infringement when it copies content (including photos, videos, and music) from another source and publishes it on a crowdfunding site. Because infringement is common and often misunderstood, a nonprofit would be well-advised to adopt an Internet policy that emphasizes that content published by others on the web does not inherently make it available for use, even with attribution. Fair use rules, which may be very complex, should also be described with practical detail.

Investment Crowdfunding

Generally, investment crowdfunding involves the selling of (1) an ownership interest in a for-profit entity (equity), or (2) a debt instrument including a promise of repayment of the corresponding loan with interest or some other financial benefit. In either case, the seller may be selling a security and falling under the purview of federal and state securities laws.⁵⁰

Soliciting investments (whether equity or debt) from the general public requires compliance with complicated securities laws, including registration and reporting

⁴⁹ See <http://www.atg.wa.gov/news/news-releases/ag-makes-crowdfunded-company-pay-shady-deal>.

⁵⁰ A very broad overview of selected federal securities laws follows. State securities laws must also be considered, noting that several have adopted intrastate investment crowdfunding laws. Further attention must also be given to other federal laws that may affect a nonprofit's sale of securities including the Trust Indenture Act.

requirements. Notable for nonprofits, the federal Securities Act exempts from the registration requirements:

Any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual, or any security of a fund that is excluded from the definition of an investment company under section 3(c)(10)(B) of the Investment Company Act of 1940.⁵¹

Other common exemptions are provided under Regulation D.⁵² According to the Securities Exchange Commission ("SEC"):

Regulation D (or Reg D) contains three rules providing exemptions from the registration requirements, allowing some companies to offer and sell their securities without having to register the securities with the SEC. For more information about these exemptions, read our publications on Rules 504, 505, and 506 of Regulation D.

Companies relying on a Reg D (17 CFR § 230.501 et seq.) exemption do not have to register their offering of securities with the SEC, but they must file what's known as a "Form D" electronically with the SEC after they first sell their securities. Form D is a brief notice that includes the names and addresses of the company's promoters, executive officers and directors, and some details about the offering, but contains little other information about the company.⁵³

Under Rules 505 and 506 of Regulation D, a company may sell its securities to "accredited investors." Accredited investors, defined in Rule 501 of Regulation D⁵⁴, include, among others:

- any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;
- any natural person whose individual net worth, or joint net worth with that person's spouse, without including their primary residence, exceeds \$1,000,000;

⁵¹ 15 U.S.C. §77c (Securities Act §3(a)(4)).

⁵² 17 CFR § 230.501 et seq.

⁵³ <https://www.sec.gov/answers/regd.htm>.

⁵⁴ 17 CFR §230.501(a).

- any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

The Jumpstart Our Business Startups (“JOBS”) Act was signed into law on April 5, 2012 with the intent to encourage funding of small businesses by easing various securities regulations. Title III of the JOBS Act created a federal exemption under the securities laws to allow crowdfunding to be used to offer and sell securities. The crowdfunding provisions of the JOBS Act were intended to help provide startups and small businesses with capital by making relatively low dollar offerings of securities, featuring relatively low dollar investments by the “crowd,” less costly.⁵⁵ On October 30, 2015, the SEC adopted final rules (“Regulation Crowdfunding”) to permit companies to offer and sell securities through crowdfunding.⁵⁶ The final rules and forms went into effect on May 16, 2016.⁵⁷

Regulation Crowdfunding, among other things, permits individuals to invest in securities- based crowdfunding transactions subject to certain thresholds, limits the amount of money an issuer can raise under the crowdfunding exemption, requires issuers to disclose certain information about their offers, and creates a regulatory framework for the intermediaries that facilitate the crowdfunding transactions. As an overview, under the final rules:

- An issuer is permitted to raise a maximum aggregate amount of \$1 million through crowdfunding offerings in a 12-month period;
- Individual investors, over the course of a 12-month period, are permitted to invest in the aggregate across all crowdfunding offerings up to:
 - If either their annual income or net worth is less than \$100,000, then the greater of:
 - \$2,000 or
 - 5 percent of the lesser of their annual income or net worth.
 - If both their annual income and net worth are equal to or more than \$100,000, then 10 percent of the lesser of their annual income or net worth; and
- During the 12-month period, the aggregate amount of securities sold to an investor through all crowdfunding offerings may not exceed \$100,000.⁵⁸

⁵⁵ See <https://www.sec.gov/rules/final/2015/33-9974.pdf>.

⁵⁶ See <https://www.sec.gov/news/pressrelease/2015-249.html>.

⁵⁷ See <https://www.sec.gov/rules/final/2015/33-9974.pdf>.

⁵⁸ See *Id.* See also 15 U.S.C. §77d(6) (Securities Act §4(a)(6)).