The Metropolitan Corporate Counsel®

www.metrocorpcounsel.com

Volume 19, No. 3 March 2011

For Technology Start-ups, A Road Map Is Essential – And It Should Cover Every Stage Of The Journey

Steven Eliach, JD, LLM and Jeanne Goulet, CPA

MARKS PANETH & SHRON, LLP

A technology start-up is a complex entity, even if its initial scale is small.

Careful planning is needed to arrive at a roadmap – not just for product development, marketing and sales, but also for a business model that ultimately will result in a great product market fit. The ideal roadmap is one that addresses the financial needs of both the entrepreneur and the business.

Just as technology approaches such as open source software and cloud computing enable entrepreneurs to stay cost-effective as the business scales up, "Scaling CFO services" – perhaps provided by an outside firm – can address life-cycle planning.

Early-Stage Decisions

Negotiating the Business Agreement

The first issue that must be addressed is the business agreement between the various founders and key employees:

- How will profits and losses be split?
- What authority will each owner have?
- What management fees or compensation will each earn for the services provided?
- Are suitable employment agreements in place?
- What happens if one of the shareholders walks away or dies?
- Will any payments be made on account of contributed funds?
- How will disputes between the owners be resolved?
- What happens upon the sale of the business?

Addressing Individual Financial Matters

With many of these financial issues there is some overlap with individual planning:

- What type of equity will I own?
- Do I have sufficient liquidity in the form of cash or credit to handle both my personal family needs and the needs of the growing business?
- Am I jeopardizing (and to what extent) my personal wealth?
- Will any of my transactions generate phantom income for me - and trigger immediate income tax prior to cash realization?
- Have compensation and stock incentive issues been properly handled?
- Will my business activities subject me to tax in other countries or other states?

Choosing the Right Type of Business Entity and Jurisdiction(s)

- Once the business deal has been worked out, the next question is, "what is the most tax efficient type of operating entity?"
- Where does the entity plan on conducting its activities?
- Will it operate or have nexus in multiple states?
- Will it have cross-border transactions, generate revenue or develop intellectual property overseas?
- What are the state and local income or sales taxes and international implications of its jurisdiction(s)? Is there a risk of double taxation?

The federal (and if applicable, overseas) tax rules will be a critical factor in many cases in the choice of entity.

Deciding How to Efficiently Manage Intellectual Property

The next issue is the financial management of intellectual property (IP). The team must work with an attorney with specialized skills who can protect IP both in the U.S. and abroad, and help determine where the IP should be owned and developed.

Planning and Operational Matters

Next on the agenda is the "first time through set-up" or accounting, as well as bookkeeping and operational matters:

- Employment and contractor agreements
- Setting up payroll, benefit and option plans and confidentiality agreements
- Budgeting
- Cash flow management
- Establishment of internal controls to prevent fraud and waste
- Analysis of sales/use tax withholding requirements
- Tax compliance
- Financial reporting system to meet legal requirements and investor needs
- Creation of financial dashboards to enable the entrepreneur to steer the business.

Critical decisions include the proper classification of individuals as independent contractors vs. employees – an issue which can carry hefty penalties if not properly addressed.

***Steven Eliach, JD, LLM,** is a lawyer and the Principal-in-Charge of the Tax Practice. **Jeanne P. Goulet, CPA,** is a Senior Consultant at Marks Paneth & Shron, LLP.*

For more information please contact Jeanne Goulet, CPA at MP&S at (212) 710-1816 or jgoulet@markspaneth.com.

Mid-Stage Decisions

As the global start-up begins to grow and generate revenue, the business may be able to hire financial staff. The "scalable CFO services" may become more strategic:

- Budgeting
- Developing financial dashboards
- Performing financial analysis of the business drivers
- Expanding business relationships with bankers to obtain new lines of credit as needed
- Broadening the tax strategy to include more jurisdiction and focusing on minimizing the effective tax rate of the business
- Assessing a risk management plan
- Developing new relationships with insurance professionals
- Assessing investment and funding activities
- Developing a "deal book"
- Evaluating potential investors
- Reporting to the Board of Directors and investors

Financial reporting, tax compliance and the entrepreneur's financial affairs may become more complex.

Late-Stage Decisions

Planning an Exit Strategy

The entrepreneur may have created a viable long-term business or may be riding a "thunder lizard" up a growth path resembling a "hockey stick." In either case, the business will need assistance in identifying and implementing a long-term strategy or an exit strategy.

Wealth Management Strategies for the Owner

Wealth management strategies including asset allocation, insurance and creditor protection need to be implemented to protect the entrepreneur from business and personal risks.

Conclusion

The business, tax, and financial aspects of organizing a start-up business are tightly integrated – as are the business and financial issues of the entity and the individual entrepreneur. Early planning and ongoing vigilance – assisted by a team of professionals – will help ensure a smooth process for growing the business and creating wealth for its owners and employees.