

## **AN INTRODUCTION TO THE GLOBAL START-UP**

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### **A Worldwide Endeavor**

Start-Ups have been around for a long time. Traditionally, they have been local enterprises run by small business entrepreneurs. Today, however, thanks to the Internet's global reach, entrepreneurs have the ability to tap networks and establish Start-Up operations all across the world.

Recognizing the potential of international markets, global IT development teams and other types of human capital, Start-Ups are emerging in areas beyond the typical US breeding grounds of Silicon Valley, Boston, New York, Washington, D.C. and Dallas. An increase in technical innovation and start-up activity is now also being seen in cities such as Bangalore, Helsinki, London, Shanghai, Singapore, Sydney, Tel Aviv, Toronto and Zurich.

No matter what the geographic origin, decisions made by Start-Ups at their earliest stages are likely to be among the most critical – as these decisions will impact their future ability to raise funds, engage in mergers or other business transactions, as well as impact their tax position and that of their outside investors.

### **Early Stage Questions for Every Start-Up**

It is at the beginning “formation stage” that Start-Ups need to begin working with legal, accounting (domestic and international tax specialists) who can ask the right questions and guide them through the labyrinth of tax rules and regulations.

#### **What?**

Initially, the first question that Start-Ups need to ask themselves is *what should I be?* A Start-Up founder/CEO can select from two main options to house the entity – a corporation or a transparent entity (pass through entity).

In the United States, the income of a “C” corporation is taxed twice - once at the corporate level and then again when the net-after-tax-earnings are distributed as dividend income to the shareholder. At the maximum Federal tax rates for individuals and corporations, this two tier taxation results in a combined tax rate approximating 44 percent (not including state taxes), using current federal tax rates. This combined tax rate may increase substantially starting in 2011.

Alternatively, a Start-Up might begin as a transparent entity, such as a Partnership, a Limited Liability Company or a US Subchapter S Corporation. These entities generally do not pay income tax on their income or losses because the owners include their share of the Start-Up's income in their own tax returns. At present, the maximum Federal tax rate for individuals is 35 percent (not including payroll tax), thus tax on the Start-Up's distributed earnings can be significantly reduced by beginning operations as a fiscally transparent entity. Subject to limitation, business losses incurred by a transparent entity might be deductible by the Start-Up's owners against other sources of income.

## Where?

The second question that a Start-Up needs to ask is *where should I base my operation? In the United States? Somewhere in Europe? In a low-tax rate jurisdiction?*

When Start-Ups aspire to go global, they often overlook the impact that international tax structures and offshore operations will ultimately have on their operations and on their investors. Start-Ups need to understand the implications and take proactive measures that will help avoid double taxation and minimize their overall effective tax rates.

There are multiple ways of approaching international tax structures. If the Start-Up will initially operate in the United States, it might still be beneficial to form the Start-Up in a foreign jurisdiction at the very outset. In the case of a Start-Up that is developing intangible assets, for example, it can be very costly to transfer such assets to a related offshore entity at a future time when value has been created. Therefore, it might be beneficial to have the intangibles owned initially by an offshore entity, even though intangible development is being performed at an arm's length price by a related US entity.

## Good Planning Is Key

The decisions of what and where to establish a Start-Up, however, are just the beginning. As we will explore in future MP&S articles, there are a myriad of domestic and international issues, that if not understood and planned for appropriately, could impact the ultimate value of a Start-Up when a due diligence investigation is undertaken, the profitability of the business is determined and finally, when an M&A or IPO occurs.

Issues such as those below are critical and should be considered by every Start-Up CEO:

**Tax jurisdiction:** Who has the right to tax my future profits? Who will provide me with tax benefits for my current tax losses?

**Foreign tax credit:** How can I avoid double taxation and stay out of the "100% Club" where my taxes equal or exceed 100% of my profits?

**Efficient tax management of intangibles:** Who is the tax owner of the intangibles? Who will enjoy the economic benefits and bear the risks and burdens of loss? Which jurisdiction(s) will be entitled to tax?

**The concept of "Arm's Length Standard":** Why do I have to set a price and charge my affiliates? We are all family and friends!

**Revenue characterization:** My lawyer calls my user agreement "a license" but why does my international tax expert call it a "sale of goods? How can my customer agreements help me to pay less aggregate income tax and more efficiently utilize foreign tax credits?

**Unexpected taxable presence:** As an owner of an enterprise, how do I make sure that my employees working abroad do not create a taxable business presence for my company in multiple and unexpected jurisdictions?

**Foreign withholding taxes:** What are my duties to governments as a tax withholding agent?

**US federal and state withholding obligation:** When do I need to withhold tax and when am I considered to be a withholding agent?

**Company and owner/investor issues:** What are the accounting and tax considerations that should be addressed over the life cycle of the Start-Up? What are the issues that will most greatly impact my fellow owners/investors and me, as well as our key employees?

If you are an entrepreneur thinking about starting a business – domestic or global – you are well-advised to seek the assistance of a full service accounting firm with international expertise that can work with your legal team and help guide you through the process.

## **FOR FURTHER INFORMATION**

For more information or to set up an appointment with a team of MP&S specialists, please contact **Jeanne P. Goulet, CPA, Senior Tax Consultant** at MP&S at 212.710.1816 or [jgoulet@markspaneth.com](mailto:jgoulet@markspaneth.com).

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