ROAD MAP OF A START-UP AND THE ENTREPRENEUR

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TABLE OF CONTENTS

INTRO TO THE ROAD MAP

A start-up venture is not just about product development, marketing and sales. It is a constant search for a business model that ultimately will result in a great product market fit.

During the course of this endeavor, the financial needs of both the entrepreneur and the business can be complex. The financial needs of the entrepreneur and the business model run on two parallel paths and can change substantially over the life cycle of the venture.

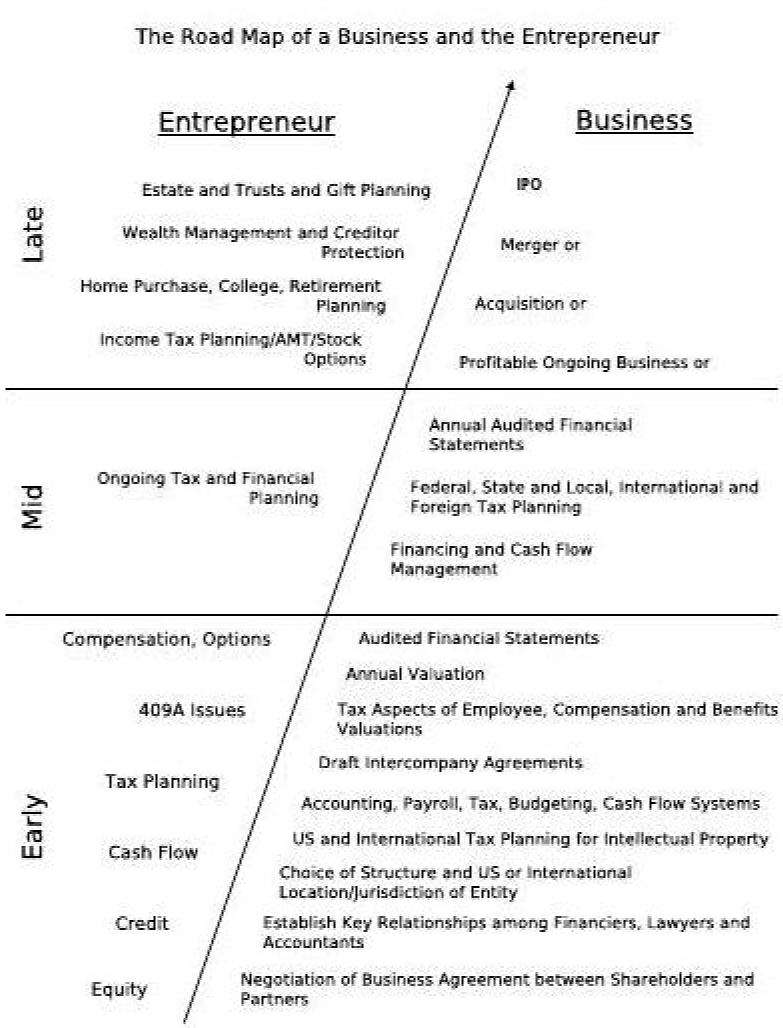
To complicate things further, few founders have an interest in dealing with financial matters. In addition, most do not have a budget for financial advice nor do they have a Chief Financial Officer as part of the founding team. There are some founders who are "Do It Yourself" CFO's. Although they are very bright, motivated and tend to focus on addressing the information and accountability needs of the venture and possibly its investors - it is less likely that they have the depth and breadth or specialized expertise needed to deal with a fast growing global business and/or interstate matters.

Just as technology, such as open source software and cloud computing, are enabling entrepreneurs to develop their products in a cost effective manner with just the right amount of computing power to meet the needs of a scaling business, the start-up and the entrepreneur also require a similar scaling of CFO services in order to develop and thrive. Such "scaling CFO services" should include the multiple and complex planning issues which arise for both the start-up and the entrepreneur over the life cycle of the venture. Initially, it should also include execution or implementation of some of the more immediate financial, accounting and tax needs of the venture.

> *Some CPA firms that are small enough to focus on small or mid-size clients but are also large enough to have centers of competency in specialty areas often have a business model that can accommodate itself to playing the role of a "scaling CFO".*

Below is an illustration of some of the financial issues – both immediate and longer term - that must be addressed for both the entrepreneur and the business over the life cycle of the start-up.

INTRO TO THE ROAD MAP



Early-Stage Decisions

Negotiating the Business Agreement

At the very early stages of development, there are several issues that apply at the business or entity level. One of the very first matters that must be addressed even before the type of entity is chosen is the business agreement between the various founders and key employees. This agreement needs to be negotiated. This negotiation will focus on such questions as:

- 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?

At this stage, an entrepreneur could benefit from the experience of a "scalable CFO" who could offer suggestions and discuss the potential outcomes that may lie ahead under various alternatives being considered.

Imagine a number of generous and well intentioned co-founders who later regretted some of their early decisions when one member of the group walked away, keeping his share and leaving the others to develop a successful business. As they initially agreed, the financial results must be shared equally at the exit regardless of individual contribution. Asking the members the right questions up front, can lead to discussions that will nip problems in the bud later on down the road.

Working with a "scalable CFO" who has experience and foresight can improve an entrepreneur's chances of properly addressing early stage business issues such as those above that are critical to determining whether a venture will ultimately succeed.

Addressing Individual Financial Matters

With many of these financial issues there is some overlap with individual planning. Therefore, of equal importance to establishing a business agreement is resolving the questions that every entrepreneur should ask themselves early on in the venture regarding their financial strength and stamina. Early in the process, owners need to map out:

- 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 from a legal and financial standpoint?" The owners, along with their attorneys and accountants, need to also consider the best jurisdiction in which to organize and operate. Many factors enter into this decision:

- 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)?

The federal tax rules will be a critical factor in many cases in the choice of entity. Although in general, a pass-through entity, such as an S corporation or Limited Liability Company (LLC) might be the most efficient structure for investors who wish to utilize losses incurred by the venture and to provide for future business flexibility, there may be overriding business reasons to use a C corporation.

Generally a C corporation is chosen because the company expects to raise capital from investors in the short term or may want to carry-forward losses to offset future income. In addition, investors may want to take advantage of temporary tax incentives such as that provided by the "Small Business Jobs Act of 2010" enacted on September 27, 2010 which, if certain conditions are met, provides for 100% exclusion of the gain on the sale of qualified small business stock if held by non-corporate taxpayers for more than five years and was acquired after September 27, 2010 and before January 1, 2011. In addition, the gain is excluded from alternative minimum tax. Prior to February 2009, a 50% exclusion was provided. The American Recovery and Reinvestment Act of 2009 increased the exclusion to 75% for stock purchased from February 17, 2009 until September 27, 2010.

In sum, the primary disadvantage of conducting business via a corporate structure – a double layer of taxation – is eliminated for this brief time period. Therefore, as a result of changing business projections of growth and profitability as well as the changing tax climate, the choice of entity must be evaluated for each unique situation.

If international operations are envisioned, not only must the legal entity analysis be conducted at the country level, but also from a US perspective in that it is possible to have a corporation for local foreign purposes but a pass-thru entity for US tax purposes. Due to the complexity involved, each business model and plan must be individually analyzed.

Deciding How to Efficiently Manage Intellectual Property

After the structuring and jurisdiction issues have been addressed, the next issue facing a start-up from a business perspective is the financial management of its intellectual property (IP). The team must work with an attorney with specialized skills who can protect IP both in the US and abroad, if appropriate, and also the team must determine where the IP should be owned and developed. Should the IP be developed in the same entity where other functions are performed or should the IP be owned and developed in another entity or another jurisdiction – that is, in other countries? What is the most cost effective way to proceed from a net-after-tax point of view?

If the new business will be global in nature, significant international tax planning issues need to be addressed to avoid double taxation and penalties, as well as to optimize future profits. Once the IP is developed and owned in the United States, it will be difficult if not impossible to move the value of that IP outside the US tax net. In addition, if the venture is coming to the US from abroad, many unique tax issues exist because the "threshold for taxability" can be relatively low. This means that entrepreneurs risk the US tax trap of subjecting their worldwide income and assets to US taxation.

Planning and Operational Matters

Next on the agenda are the "first time through set-up" or accounting and bookkeeping operational matters as well as financial planning activities that are required for new ventures such as:

- 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.

EARLY-STAGE DECISIONS

It is not uncommon for start-ups to be lax when it comes to financial matters. However, there are various decisions involving professional judgment that must be made including the proper classification of individuals as independent contractors vs. employees – an issue which can carry hefty penalties if not properly addressed. Contrary to popular beliefs, corporations or LLC structures do not completely shield the owners from certain liabilities. Omissions and errors in the employment and sales/use tax areas can create exorbitant personal liabilities on the part of the entrepreneur or even members of the Board of Directors.

The failure to act on any of these tasks, at this stage, could result in substantial costs upon tax examinations - which in turn could cause significant distractions and disrupt the core business. In addition, errors committed at this stage can give rise to large legal fees in the future when a company is sold because a future buyer will want to receive indemnifications against liabilities generated from these early missteps.

When an entrepreneur looks at this list, it is easy for him or her to become overwhelmed and ask the obvious question of "how can I be a lean start-up and operate on a limited budget?" The answer is not to bury your head in the sand. The better solution is to engage "scalable CFO services" and bring expertise to bear when and to the degree required. A budget-conscious entrepreneur can create a "cocktail" of skills that blends the advanced expertise of an experienced CFO to be offset by the more inexpensive yet necessary skills of a part time bookkeeper or administrator - or even yet, one of the members of the founding team who has the interest. The benefit of doing it right the first time not only speaks to the professionalism and business savvy of the entrepreneur but also saves money in the long run.

Mid-Stage Decisions

Up until this stage, the entrepreneur may be using the services of the “scalable CFO” who has been functioning not only as a financial, accounting and tax advisor but perhaps also has been involved in launching the venture. As the global start-up zeroes in on its market plan and begins to grow and generate revenue, the business may be able to hire staff who can take over some of the day-to-day financial matters. The “scalable CFO services” now needed by the entrepreneur may morph into more strategic initiatives in terms of:

- 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

In addition to the above, as the firm grows, financial reporting and the tax compliance function will become more complicated and may include multistate filings. The expansion of the business will require more state and local tax planning as well as possible international tax planning.

At this stage, parallel with the growth of the business, the entrepreneur’s financial affairs may become more complex as well. If he/she has received distributions, regular tax and alternative minimum tax as well as financial planning may be in order. Cash flow management and setting aside funds for the future may be necessary as well. It may also be advisable to hire the services of a trusted investment advisor. A “scalable CFO” can assist the entrepreneur in these decisions to make sure that the best services are received at a reasonable cost.

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. This might involve a sale to a publicly traded company or an initial public offering. There is also the possibility of a sale to a large privately held company. No matter what the final outcome of the exit strategy, the owner will need a team of professionals to help structure the deal to achieve the best financial after tax result.

Wealth Management Strategies for the Owner

At this point, wealth management strategies including asset allocation, insurance and creditor protection need to be implemented to protect the entrepreneur from business and personal risks. If relationships with professionals have not already been created, the time has come to assemble a financial team that will assist the entrepreneur in preserving his or her well-earned funds. Money may need to be placed in a "college fund" and debt and asset management may need to be addressed. The entrepreneur may also want to consider some tax-efficient charitable giving. Of great importance to wealth preservation is estate-planning strategies. Although some of these work best if implemented before the business has become too valuable, there are nevertheless strategies that can be deployed at this stage.

Conclusion

As this brief summary shows, 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. At this point, it is easy to see that to fulfill the needs of a start-up and the entrepreneur, a wide range of very specialized skills are needed to maximize the financial outcome.

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 the right size, business model and international expertise that can work with your legal team and help guide you through the process.

For More Information

For more information or to set up an appointment with a team of MP&S specialists, please contact Jeanne Goulet, CPA at MP&S at 212.710.1816 or jgoulet@markspaneth.com.