CERINI & ASSOCIATES LLP

CERTIFIED PUBLIC ACCOUNTANTS

# BUSINESS INSIGHTS: TECHNOLOGY INDUSTRY

A BEST PRACTICE RESOURCE FOR TECHNOLOGY EXECUTIVES

# INTRODUCTION

America's business engine has been built on the innovation and technological advancements of entrepreneurs, individuals willing to take the risk of business ownership head-on, developing new ideas, creating millions of jobs, and sparking the imagination of the next wave of entrepreneurial pioneers. Over the last twenty years, we've experienced a technology explosion. Advancements are being made daily, and technology is at the forefront of robotics; nanoscience and nanotechnology; biomedical science; computer science; aeronautics; pharmacology; medicine; physics; entertainment; transportation; and so much more. As the owner of a technology-based business, you have set out to make a difference and help shape the future of the world. Unfortunately, statistics show that many of you will fail due to undercapitalization, a lack of business skills, poor timing, changing markets, etc. Others will succeed, whether while staying a private business, selling out to a larger strategic partner, or going public. *And you never know,* you may become the next Apple, Google, Facebook, or Amazon.

The path to success is marked by many obstacles. Having a navigational system to guide you along the way can help ensure that your business doesn't break down before it reaches its destination. If you ask any successful business person for his/her key to success, you may hear that you need to surround yourself with the right individuals. To succeed, you need strong leadership, dedicated employees, and a team of knowledgeable advisors who can help you understand and avoid the myriad of potential pitfalls that can undermine your success.

Cerini & Associates has created this guide for you, the technology-based entrepreneur, to provide some assistance and insight into some of the issues that you will face, because we are interested in your success. We have decades of experience working with technology-based companies, so we're in a great position to help you direct your business. *We are not traditional accountants.* We are strategic business partners helping each of our clients navigate the ever-evolving business and regulatory landscapes to maximize their potential.

Please let us know how we can help you leave your mark on the world.

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GRAPHIC DESIGNER:
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# 5 KEY CONTROL ISSUES FACING TECHNOLOGY COMPANIES

Today's businesses operate at the speed of data. A company's ability to access information; reach people; open markets accessible through phones and tablets; and push data throughout its operations, is essential to effectively operate its business. Systems that track inventory on a real-time basis provide instant customer relationship information, aid in search engine optimization, and process payments efficiently and effectively are worth their weight in Bitcoins. Technology-based companies are often on the leading edge of data movement and storage, which bring up key control issues that are not necessarily unique to technology-based companies, but should weigh heavily in their assessments of risk and design of internal controls.

## 1: CYBER SECURITY

This has become a major focus for all companies, but it is even more of an issue for technology-based companies. With the ever-increasing push to the cloud, new capabilities and sophistication of software, the better funding of hackers (*organized crime, nation states, insiders, etc.*), and the inability for companies to monitor and regulate the use of equipment and applications by their staff (*e.g. cell phones*), it is getting more difficult for companies to protect their data and the data of their customers. A data breach can result in significant losses to a company's reputation and its bottom line. It is critical that technology companies stay abreast of new emerging threats and protection criteria on the market to avoid costly losses. In developing proper cyber controls, companies need to consider both high-tech and low-tech intrusions and develop systems and controls to protect against these. Limiting access to sites (*e.g. Facebook*), training staff about phishing scams and other cyber threats, performing regular intrusion detection protocols and running data loss prevention software, implementing and updating firewall securities regularly, performing staff background checks, controlling access management, and ensuring proper encryption and transference of sensitive data are some of the many security issues that need to be reviewed and assessed on a regular basis. You need to consider these and other factors when developing your company's IT policies, which should also include regular reviews of your systems and your security incident response and communication plans.

## 2: DATA COLLECTION AND USAGE

They are now the lifeblood of any company. The more real-time and accurate your data flow is, the better decisions your management team can make. Data flows like a stream, so you need to understand its source, how it is flowing, and where the impediments to a steady flow are. In evaluating your data collection and usage systems, you should consider:

- **What data you need to collect:** *The collection and protection of data can be pricey, so it is important to define what source data is going to have the most meaningful impact on your business operations. Things like inventory flow, product sales, customer feedback, etc. are all potentially important factors to capture information on.*
- **Where this data is coming from:** *You need to identify what the source of the needed data is, who has access to it, how is it being accumulated, how accurate is it, and how timely is it.*
- **How the data is being collected:** *Do you have protocols in place to ensure you are collecting the appropriate data? Who is entering the data into the system or is the data being automatically pulled from a source? How do you ensure proper notification if data entry fields change? Is the data appropriately stored to prevent inappropriate access? And are confidentiality standards in place to ensure security of data?*

- *How do you validate the quality of the data collected? Have procedures been designed and implemented to ensure validity, reliability, completeness, timeliness, integrity, and confidentiality of the data accumulated? This can include staff communication and training, systems checks, and built-in quality assurance protocols.*

- *How do you accumulate the data for meaningful reporting? It is great to have data, but data without the ability to manipulate and use it is useless. You need to have the ability to filter the data and pull it into meaningful reporting that can be a tool for management decisions. Reporting should be used to help drive positive results in the areas you chose to measure.*

When collecting data, it is important to understand which aspects of your business drive results, such as faster throughput, higher customer loyalty, and satisfaction, meaningful searches, etc. and these are the areas where you want to focus your resources. Remember that this is not a static process; you should constantly rethink the data you are collecting for appropriate decision-making.

## 3: STAFF ACQUISITION AND RETENTION

Because for all of us, time is finite, you need to leverage the work you perform through others. The goal is to focus your energy on the areas where you can create the most benefit for your company, but this means trusting others to help you in other facets of your operations. When bringing on staff members, you need to create good open communication and develop an appropriate culture, but you also need to develop appropriate documentation and structure, so everyone understands what is appropriate in the workforce. Developing organizational charts, job descriptions, employee handbooks, human resource/ benefits policies, performance reviews, conflict of interest policies, covenants not to compete, confidentiality policies, and the like, are helpful in setting an appropriate tone for the workforce. This doesn't need to squash creativity; it instead should provide a framework for your company and its personnel, which for many companies is its most valuable resource. For many new technology companies, salaries are not always competitive. In order to attract and retain a quality staff, you need to find a way to blend compensation with other work-related factors such as a collaborative and relaxed work environment, learning experiences, extra time off, and maybe even bonuses for reaching production milestones or sales levels. The cost of hiring and retraining new staff gets expensive, so the goal of retention is crucial.



5 KEY CONTROL ISSUES FACING TECHNOLOGY COMPANIES

## 4: DIGITIZATION OF PROCESSES

In the past, systems, and cycles, including manufacturing processes, while automated, still had a significant level of low-tech labor involved. This created significant risks by way of safety, quality, and slowdowns in the production cycle. Progress only moved as fast as the slowest man or woman on the line. Today, with new developments in intelligent machines, 3-D printing, modeling and simulation, plant and floor analytics, and big data; processes have become much more automated, and the production floor has gotten smarter and more efficient. New concepts can be brought to the production floor so much faster. With that, however, come new challenges. Just like the auto mechanic today needs to understand the complexity of the core processing that runs today's smart cars, manufacturers need to ensure that staff understands the complexities of today's production cycle. The concepts have not changed, the level of sophistication has. Ensuring equipment is in working order, with regular maintenance schedules, review of production outputs, and routine diagnostics, can help ensure that a system failure will not wipe out a month's worth of profits. In addition, with the speed of new product development and bringing those products to market, companies need to make sure that they are doing their due diligence to protect their research and development pipelines through comprehensive development policies and employment contracts, as well as progressive patent practices, to ensure that as products are developed, they can securely get to market in a timely manner.

## 5: CLOUD-BASED SERVICES

Data is moving to the cloud at unprecedented levels. Nearly one-third of all corporate data currently resides on the cloud, as more and more companies shift from licensed software to software as a service applications (*SaaS apps*) through cloud-based alternatives.Controls surrounding cloud alternatives are not as strong as most people believe. Popular sanctioned SaaS apps like Office 365, Salesforce.com, and Workday are just beginning to recognize the need to bring necessary transparency with regard to user activity. Employers utilize SaaS apps because of the: flexibility to access, built-in innovation, automatic maintenance and updates, and the cost, as they tend to be cheaper than traditional licensed software solutions.Unfortunately, according to some studies, only about 6% of SaaS apps are considered enterprise-ready, meaning they have mitigated the high level of security and compliance risk associated with SaaS apps. Unique cloud risks include certifications and standards, data protection, access control, auditability, business continuity, legal, and privacy issues, and vulnerabilities and exploits. For example, a popular SaaS app that many people use instead of PowerPoint states in the fine print of its user agreement, that it owns any of the data uploaded to the site.That should be a red flag to anyone concerned about safeguarding sensitive information. Good housekeeping in the cloud requires you to identify, assess risks, control, and optimize the use of cloud-based services.

These are just some of the risk areas faced by technology-based companies. With new employment law regulations, pension requirements, cash management concerns, and general issues with the safeguarding of assets, companies need to ensure they are investing in proper infrastructure, not just to handle their business operations today, but are also scalable to be able to handle future growth.

# THE FUNDING PROCESS

HAVING AN INNOVATIVE CONCEPT THAT CAN CHANGE THE WORLD IS ONLY HALF THE BATTLE FOR TECHNOLOGY COMPANIES. HAVING THE RESOURCES TO TURN THIS IDEA INTO A SUCCESSFUL BUSINESS IS THE NEXT STEP IN HELPING TO ACHIEVE THE DREAM. MANY EARLY STAGE AND STARTUP COMPANIES WILL OFTEN SEEK OUTSIDE FUNDING THROUGH A VARIETY OF MEANS. UNDERSTANDING THESE METHODS AND THE PROCESSES INVOLVED IS CRITICAL AND MUST BE CAREFULLY CONSIDERED.

## FRIENDS AND FAMILY ROUND

Many, but not all, companies will initially capitalize via a friends and family round. This round is often more informal, and used for the initial formation of the company and product development, bridging the gap between a concept and a business. While less involved than other financing processes, this does not mean that legal requirements and processes should not be followed. The investment can be structured as either debt (*a straight loan or convertible debt*) or equity (*stock or other ownership*), and should have the proper legal elements in place, such as written evidence of the investment, stock certificates, capitalization tables, and approval by the board for the capitalization. Since there is likely not a fully-functional business enterprise in place yet, most of the documentation that the investors will want to see relate to the idea itself, how far along you are in development, and some projections of when investors will see a return.

Companies should be wary of selling too much of the company in this initial round and what types of rights these instruments have, as having too generous a set of rights or selling too much may impact future funding round. If using equity to capitalize, it is usually preferable that the founder's shares be of a different class than the common shares sold to friends and family, with different voting and dividend rights. Founder's shares should allow the founders to control the company, while the common shares should allow for a return on the equity of the investors.



## SEED ROUND/SERIES A

The seed round is typically the first round of funding from professional investors, such as venture capital and private equity funds. Seed investors tend to be savvy and because they are getting into the business early, these investors will often want a larger stake of the company with more generous returns. A seed round will be documented very formally. It is not uncommon for a seed financing agreement to be over forty pages covering representations and warranties of the buyer and seller and other legal protections. Typically seed rounds will be a preferred stock, with a higher liquidation preference than any previously-issued common stock or founders' stock. Seed investors will also want to have some sort of *"handcuffs"* on founders, usually in the form of vesting options, vesting stock, and rights of first refusal.

Often seed investments are made after an idea has become more than just a concept, but is rather a promising business operation. As such, many seed investors will want to see historical financial data (*usually for the trailing twelve months*) and projections for three years going forward. Having reliable and accurate financial data is key here, since this is one of the factors that these investors will be heavily relying on in making their investments. Many investors often love an idea or concept, but when presented with financial data, get cold feet on the investment.

At this stage investors are often most concerned about cash *"burn,"* or how much cash the company uses each month. Using historical data and projections, investors will want to know how much *"runway"* a company has, or how long until the company is out of cash to fund operations. As a company seeking investment, this metric is equally important to you as well. The size of your financing should be related to this calculation. Investors will not want to see or hear that a company did not ask for enough cash during its initial raise, thereby requiring subsequent, expensive, and potentially dilutive transactions.

A seed round will typically remain open for 30-90 days after initial investment, but rarely does any additional funding come in during this period. The lead time for a seed round can vary, but usually takes about 90-120 days to close, if not longer. After the investment, investors will begin to request additional financial information on a monthly or quarterly basis so as to monitor their investments. Larger raises may even require the company to issue audited financial statements.

## SERIES B AND BEYOND

Capital funding after an initial seed or Series A round is typically referred to as the next letter in the sequential order (*Series B and then Series C and so on*). Having been through a formal capitalization prior, the company will already be familiar with many of the different forces at play. A Series B round will nearly universally have be to offered to any Series A investor as part of the initial raise, and then can be opened up to new investors. Since the company is more mature than during the Series A round, the valuation is often higher, thereby requiring selling less of the company for more money and also allowing for shareholder rights that are less favorable to the investors than in Series A. Series B will still often be preferred stock, subordinate to Series A but superior to common or founders' shares.

A Series B raise will require all of the same legalities as the Series A raise. Investors will still look at historical and projected financial data, but now will focus more on the potential returns and future profitability than with a Series A. Investors will not want to continue to fund companies with their own money. They will be looking for the company to become profitable and begin to generate positive cash flow on its own. Often, a Series B or later funding will take place in order to take advantage of a new opportunity, whether it is the acquisition of a competitor, a technological breakthrough that will require more resources, or a pivot to a new product/service line that was not previously part of the business plan. Other times a Series B is used when the company is still in an early stage development and burning cash, but shows more potential than at the original Series A.

Understanding the different funding processes and terminology is crucial for technology companies. Having the resources available to execute is what separates the great ideas from the great companies. It can be tricky to navigate getting these resources, but the potential rewards are worth the risk and the effort.

# EQUITY-BASED COMPENSATION

In order to attract and retain qualified talents, technology companies often will use equity based compensation. This method of compensation is beneficial for technology companies for several reasons:

1. *There is no out-of-pocket cash cost.*
2. *It aligns the goal of growth between the employees and the company.*
3. *The vesting schedule allows companies to retain talent and minimize turnover.*
4. *Years of this practice have made it the norm for many technology companies.*

The exact mechanics of equity based compensation depend largely on how the company is legally structured and how the company is taxed. While both corporations and LLCs can use equity compensation, the arrangements are very different for each, particularly in regards to the taxation.

## CORPORATIONS & LLCS TAXED AS CORPORATIONS

With an LLC taxed as a corporation, there is no difference in the taxable effect on the business as if it were organized as it as a traditional corporation. Corporations generally have three different methods of compensating employees.

**Incentive (Qualified) Stock Options (ISO):** ISOs for established and publicly-traded companies are typically offered to executive-level employees and have significant restrictions on their exercise and grant. However, for early stage technology companies, it is more standard for this class of option to be offered to all employees, not just executives. Companies are looking to assist in creating the best potential tax outcome for their employees, and the use of ISOs versus NQSOs allows for minimal ordinary income and potential for large capital gains on disposition. These options do not offer any corporate-level deduction for the company, and as such, do not have any tax effects on the grant to the employee.

**Non-Qualified Stock Options (NQSO):** NQSOs are more common options that can be granted to both employees and other service providers. These options will have a strike price (*how much the shares will cost the employee*) and often an expiration. The difference between the strike price and the value of the shares represents the taxable portion of the grant, known as the bargain element. Neither the corporation nor the employee recognize a taxable transaction on grant; the taxable event is during exercise. The difference between the option strike price and value when exercised represents compensation to the employee and a deduction for compensation on the corporate level. For private, early stage technology companies, these options are very rarely used.

**Restricted Stock/Restricted Stock Units:** Restricted stock can be considered the sister of ISOs. Restricted stock refers to shares typically awarded to an executive-level employee. The shares are often subject to vesting schedules, with the employee losing any shares that haven't been vested. The employee will recognize income when the shares vest and are no longer subject to forfeiture; the company will recognize a deduction at the same time. There are some legal differences in contractual nature between restricted stock and restricted stock units; however, their tax treatment is mostly the same.

Companies that issue equity based compensation will need to make sure that the formalities of such are in place. The company will require a written plan with board approval for these shares. Typically, they should only represent a small pool of the overall equity of the company. Many companies have run into issues where their plans or grants were not properly written and approved, leading to taxation issues and multiple lawsuits over these grants.

## PARTNERSHIPS & LLCS TAXED AS PARTNERSHIPS

Unless an LLC elects to be treated as a corporation, the entity will default to being treated as a partnership. In early startup years, a partnership structure benefits owners since the losses will pass through to their personal tax returns, allowing them to potentially take these losses against other income. Additionally, many investors enjoy the benefits related to a single layer of taxation rather than the additional tax costs of an incorporated structure. Partnerships differ greatly in both the nature and planning opportunities for equity based compensation. There are two primary methods for equity based compensation in a partnership.

**Capital Interest:** A capital interest refers to a grant of partnership equity to an employee that includes a right to the equity of the business prior to the date of the grant. Said another way, the employee gets to share a percentage equal to the grant of all of the value of the business prior to the grant. A capital interest is determined by the liquidation rights on the date of the grant. If the employee is entitled to assets upon liquidation, then it is a capital interest.

A capital interest will give rise to a deduction to the business equal to the value of the newly created capital account, and the employee will recognize ordinary income equal to the deduction taken by the business.

**Profits Interest:** The IRS broadly and foolishly defines a profits interest as *"any interest other than a capital interest."* In practical terms, a profits interest represents an interest in the future appreciation of a partnership from the date of grant. From the date of the grant, the employee will share in the profits and losses of the partnership equal to his or her percentage grant and begin to create a capital account which represents the appreciation the partnership from the date of grant. An important feature of a profits interest is that the grantee has no liquidation rights on the grant, only on the future appreciation.

Given that at the date of the grant, the employee is not being given anything other than a right to future growth, the business will not recognize a deduction for the grant and the employee will not have any income.

Different business structures allow for different methods of rewarding employees with equity compensation, each with different tax effects for the businesses. On top of compensating employees for their hard work, equity based compensation can often align the goals of the business with the goals of the employees to help maximizing value of the firm and to encourage growth. With the multitude of options it is important for all businesses to make sure they understand their choices and how these different forms of equity compensation will affect their taxable situations.

# TOP HR/PAYROLL TIPS FOR TECHNOLOGY STARTUPS

**Human Resources** (*including payroll*) is often one area that technology companies tend to neglect in their earliest stages. While many companies will have a payroll processor or a **Professional Employer Organization (PEO)**, HR tends to fall to the responsibility of an office manager, administrator, or finance person who may have some prior knowledge but not all that is required to properly mitigate the many risks associated. As they grow, many technology companies do not handle these problems, often leading to later lawsuits and public relations issues, as well as controversy with federal, state, and local taxing authorities. Here are some tips that can be used to help with payroll and HR:

## USE A PAYROLL PROCESSOR (PEO)

Payroll processing companies, such as Paychex and ADP, will process payroll for companies, allowing for payment of taxes, filing of returns, and direct deposits to employees. The processor assists you with these tasks, but ultimately the responsibility is still with the company and its officers. The employees' wages are reported under the **Employer Identification Number (EIN)** of the company, and the company is required to file a quarterly and annual return with the appropriate states and federal authorities. Given that the company is still processing payroll on their own, the processor offers little in the way of HR support and relieving the administrative burden.

An alternative to a payroll processor is to use what is known as a PEO. In this case, you enter into a co-employment relationship where the employee is still an employee of your firm, but their wages are reported on the EIN of the PEO. The benefits of a PEO include additional HR support, access to lower group health rates, and a much-decreased administrative burden.

## UNDERSTAND THE COMPLIANCE BASICS

Compliance with federal, state and local authorities is crucial when considering payroll. Compliance work includes proper registrations with the IRS and states where you have employees, maintaining required insurance coverage like workers compensation and disability, having all required employment documents, and the timely filing of payroll tax returns.

The major employee documents required for compliance are IRS Forms I-9 (*employment authorization*) and W-4 (*employee withholding*). These should be completed, along with any supplemental paperwork, prior to starting employment.

Payroll tax returns are due quarterly to the IRS and states. IRS Form 941 is used to file federal taxes, and then each state will have its own equivalent. Any states where you have an employee you will need to file a return.

## PERSONNEL FILES

On top of the required documentation above, an employee's personnel file should have supplemental documentation as needed. These should include copies of resumes, performance reviews, and any disciplinary actions, as well as additional documentation as decided by your company. Some additional documentation we recommend include the following:

a. *Background checks*
b. *Non-compete clause*
c. *Confidentiality agreement*
d. *Photo releases*
e. *Employment agreement, if any*
f. *Equity compensation agreements, if any*

## EMPLOYEE HANDBOOKS

Your handbook should, at minimum, cover all legal requirements needed to satisfy state and local regulations. This may require an additional supplement for certain states on top of the general handbook. The handbook should also cover all major company polices, including vacation time, expense reimbursement policies, Internet and email usage, data storage and protection, and employee codes of conduct. Many payroll processors and PEOs can assist with these, but it should also be reviewed by legal counsel. The employee handbook is where you set all the policies you want the company to have; however, having policies is only half the battle. As part of effective HR, these policies need to be enforced and documented properly, or else they exist as part on paper only.

The technology industry will always be on top of its game with ever-changing advances, enabling them to work remotely (*possibly resulting in employees and contractors working in various states*), using the latest and greatest technology (*potential concerns for cyber security and strict email/social media policies*), and working various hours from various devices (*leading to potential issue with tracking payroll hours, overtime, etc.*). Making HR and payroll a dedicated process early can help them to avoid the litany of issues that can plague technology companies, and often times even put the founders and officers at risk.

# INITIAL LEGAL CHALLENGES FOR EARLY STAGE TECHNOLOGY COMPANIES

## FOUNDER PLANNING

Early stage technology companies typically run into legal trouble when differences arise between founders regarding:

- ***Money***
- ***Control***
- ***Time commitments***
- ***Vision***

And founder relationships go from bad to worse because:

- ***Founders delayed key formation decisions***
  - Founders often don't initiate tough conversations with co-founders because they hesitate to come off to fellow co-founders as *"the one who thinks that this won't work out"*
  - Most founders want to devote their time towards more direct company-building efforts in areas they are more familiar with
- ***The company has poor corporate hygiene***
  - Foundational legal documents are missing or incomplete
  - After formation, the company put existing documents onto a (*virtual*) shelf, and did not involve counsel in ongoing decisions post-formation, such as:
    - *Hiring the first non-founder team members*
    - *Engaging consultants*
    - *Early stage fundraising*

## HAVE THE HARD CONVERSATIONS EARLY, AND THEN DOCUMENT THE AGREEMENT

The best way for founders to reduce the impact of (*almost inevitable*) changes in founder relationships is to work with counsel to address equity and governance issues from the start. This permits company counsel to hardwire the capital and governance structure so that expectations are clear. When the result of changes in direction can be predictable, the company can avoid costly re-negotiation of structure, and reduce the likelihood of one of the most frequent and demoralizing results of deferred decision making: that a founder opting to leave the company will have leverage over those who want to stay and continue to build.

## QUESTIONS TO ADDRESS UPFRONT:

- *What is the equity split?*
- *How much equity should be reserved to incentivize non-founder employees, advisors and consultants?*
  - *Who will hold the board seats?*
  - *Who will hold what officer positions?*
  - *What are the expectations for time commitment?*
  - *How will conflicts be resolved?*
  - *What is the vision for the company?*
  - *What vesting schedule will be used for founder equity?*

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# INTELLECTUAL PROPERTY PRIMER

Almost every business, whether a startup or an established company, has **Intellectual Property ("IP")**. IP provides your business with a competitive advantage. Examples include a name, logo, invention, customer list, or website, all of which are valuable business assets that should be protected. For startups especially, successful companies must understand how to identify and protect their IP. Here are some pointers that every startup should consider.

## 1. MAKE SURE YOU OWN THE IP

In the early stages of a startup, individuals typically collaborate informally to develop their ideas, and there may be no formal agreements among them. But without a formal agreement as to ownership of the IP, disputes may arise. Further, the individuals in a startup may be bound by other agreements with their current employers, and may even be required to assign the IP to their employer. Therefore, ownership of IP should be openly discussed and agreed upon. When the company is formally set up, formal agreements should then be executed.

## 2. PREVENT INADVERTENT DISCLOSURE

Startups typically share too much information with others in the beginning, whether out of excitement for the new endeavor or to attract investors. While disclosure of some information is necessary to build the business, confidential ideas or plans are at risk of accidental disclosure – and in some cases, the public disclosure of IP may adversely affect IP rights. To mitigate this risk, consult with an experienced IP attorney to help determine what information can be disclosed without compromising your rights. Also consider using a formal nondisclosure agreement.

## 3. PROTECT YOUR IP

Once a startup has identified its IP, it's time to look to potential IP protection. Protection can come in the form of trademark, copyright, patent, or trade secret. The protection available depends upon the IP at issue. Determining the type of IP protection available at the start will help a startup plan and develop its internal policies and procedures and help secure its competitive advantage in the marketplace.

## 4. DEVELOP AN IP STRATEGY

A startup should develop a strategy for how it will continue to pursue and protect its IP. Developing an IP strategy will support the company's growth from the beginning and also provide for an exit strategy. Work with a professional to determine an appropriate strategy that meets your goals and sets a framework to achieve them.



INTELLECTUAL PROPERTY PRIMER

## 5. LEARN HOW TO PROTECT EMPLOYEE-GENERATED IP

Most companies assume that any IP created by employees for their job automatically becomes the employer's property – but this assumption is often incorrect, and can lead to lengthy and costly disputes. Generally, an employer's right to such IP depends on the circumstances of the employee's hire and whether the parties entered into an agreement that assigns the IP to the employer. Companies seeking to avoid such disputes should have employees sign an Inventions Assignment Agreement.

Without an agreement, although laws differ by state, the following general principles apply: **(1)** for employees employed to invent (*i.e. engineers and scientists*), the inventions are generally owned by the employer even if the employee did not sign an agreement; **(2)** for general employees (*i.e. sales and marketing*), who have not been hired specifically to invent, the general rule is that the employee owns such inventions if there is no agreement providing otherwise; and **(3)** for general employees whose inventions do not relate to the business of the employer, these inventions are generally owned by the employee absent an agreement.

## 6. UNDERSTAND WHAT *"WORK-FOR-HIRE"* REALLY MEANS

If your company is involved in software development, you've undoubtedly come across the term *"work-for-hire."* Typically, companies needing software developed enter into written contracts with an independent contractor and insert the magical phrase *"work-for-hire,"* thinking it will automatically assign ownership of the IP to the company. However, entrepreneurs should know that works created by independent contractors constitute a *"work-for-hire"* only in very limited instances.

Works created by an independent contractor can constitute a *"work-for-hire"* only if: **(1)** the work is specifically ordered or commissioned; **(2)** the parties expressly agree in a signed written agreement that the work shall be considered a *"work-for-hire"*; and **(3)** the work is ***(i)*** *a contribution to a collective work,* ***(ii)*** *a part of a motion picture or other audiovisual work,* ***(iii)*** *a translation,* ***(iv)*** *a supplementary work,* ***(v)*** *a compilation,* ***(vi)*** *an instructional text,* ***(vii)*** *a test,* ***(viii)*** *answer material for a test, or* ***(ix)*** *an atlas. 17 U.S.C. §101.* Obviously, software does not fit neatly under one of these nine limited categories because it was not contemplated by the Copyright Act when drafted decades ago.

Some lower courts have determined that software programs satisfy the definition, but until there is a Circuit Court decision holding that computer software fits under one of the enumerated categories to qualify as a *"work-for-hire,"* the law remains uncertain. Companies should be aware that use of the phrase *"work-for-hire"* may not fully guarantee that ownership will be assigned in a software development contract. Thus, to ensure that all works prepared by the independent contractor are assigned to your company, the best approach is to use the *"work-for-hire"* recitation in conjunction with an express assignment provision.

When building your company, consulting with an IP professional to help understand your rights and how to protect them is well worth the effort.

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# RESEARCH & DEVELOPMENT
# TAX CREDITS

The **Credit for Increasing Research Activities**, or as it's more commonly known, the **Research and Development (R&D)** credit, is a federal tax credit designed to benefit businesses who conduct certain qualifying R&D activities. With the passage of the **Protecting Americans from Tax Hikes (PATH) Act of 2015**, the R&D credit has now been made permanent for all tax years beginning on or after January 1, 2015. Prior to that, it was renewed on an annual basis as part of the annual tax extenders package. Now that the R&D credit is permanent, businesses can plan and conduct research activities confidently and know for certain that their activities will qualify them for a credit at tax-time.

In order to determine which activities qualify for the R&D credit, the IRS adopts a four-part test. *First,* the activity must be undertaken for the purpose of developing a new or improved product and/or business component. If improving a product or business component, the improvement must increase performance, quality, reliability, etc.; a purely cosmetic change would not constitute an improvement. *Second,* the activity must be undertaken for the purpose of discovering new information intended to eliminate uncertainty relating to the method of development or plausibility of the product design. *Third,* the activity must be technological in nature and fundamentally rely on the principles of physical or biological sciences, engineering, or computer sciences. *Fourth,* the activity must involve a process of experimentation during which the business creates and tests hypotheses, evaluates alternatives, and ultimately draws conclusions based on results.

If an activity meets all four of these tests, then certain expenses related to the activity may qualify for the R&D credit. Eligible expenses include payments for qualified services, supplies, and personal property used in the conduct of qualified research, and certain contract research expenses. Payments for qualified services include wages paid to employees conducting the research activities and also the wages of employees who are directly supervising and directly supporting the research activities. Wage expense is only eligible to the extent the individual spent his or her time actually performing the activities. However, if an employee spends substantially all of his or her time conducting qualified research, defined as 80% or more, then the entire amount of wages for that employee will be deemed eligible. Contract expenses include amounts paid to independent contractors and outside organizations for the performance of qualified research. The IRS puts a 65% limit on these expenses although there are 100% and 75% exceptions for certain qualified research organizations.

Once a business has calculated its qualified research expenses, the next step is to calculate the credit. There are *two different* methods for calculating the R&D credit: the **regular method** and the **alternative simplified method**. The regular method requires more information to calculate, but generally yields a higher credit amount than the alternative simplified method. In order to calculate the R&D credit using the regular method, a business will need to know its amount of qualified research expenses in the current year, the average amount of annual gross receipts for the previous five-year period, and the number of years in which the business had qualifying R&D expenses prior to the current year, if any. For startup companies, putting together these records is relatively simple. However, for companies that have been in business for many years, it can be difficult and cost-ineffective to determine exactly what year the first R&D expenses were incurred. Companies in this situation would be better off using the alternative simplified method calculation. Under the alternative simplified method, the business needs only to know its qualified research expenses in the current year and the previous three years. In general, the alternative simplified method yields a lesser credit than the regular method, but for many companies this is a worthwhile tradeoff as it does not require the review of financial records dating back to the business' inception.

After calculating the allowable R&D credit for the tax year, the business has multiple options as to how to apply it. Previously, the R&D credit was treated solely as a component of the general business credit meaning it could only be used to reduce the business' tax liability. If the business had no tax liability in the credit year either due to an operating loss or the utilization of another credit, any unused R&D credit could be carried back one year and carried forward twenty years. *This may seem fine,* but many new small businesses do not see net income for many years after they begin operations and therefore it could be years before they see the benefit of the tax credit. To remedy this, lawmakers added two new ways that the R&D credit could be utilized effective for tax years beginning January 1, 2016 or after: against the business' **Alternative Minimum Tax ("AMT")**, or against the employer portion of FICA payroll taxes. These two alternative applications are only available to eligible businesses. To qualify for the AMT offset application, a business must have less than $50 million in average gross receipts for the preceding three years. To qualify for the payroll tax application, a business must have under $5 million in gross receipts during the current year and they must not have had any gross receipts before the five-year period preceding the current year. Both of these methods offer the potential for businesses to utilize the benefits of the R&D credit much sooner than ever before.

Many different types of businesses, even if they are not in a traditional research and development industry, can benefit from the R&D credit. A plethora of activities qualify and it is definitely worth a review to see if one or more of the activities that your business is performing may be among them. It is also highly advisable to consult a tax advisor as it is possible that you can amend previous years' tax returns to claim additional benefits. They will also be able to advise you on the nuances of the R&D credit as certain areas can become fairly complicated.

# NEXUS & SALES TAX

One of the most challenging taxation issues that technology companies face is sales tax. Unlike income tax, which is generally the same between federal tax and state tax, just at different rates, sales tax has a different base (*some transactions may be taxable in one state but not another*) for each of the fifty states and then different rates at the state and even local county levels. Further compounding this issue is the speed at which technology changes as opposed to state tax laws, which are normally years behind technological changes. Trying to fit innovative new technologies into older definitions leads to more confusion.

## NEXUS

To start, in order to even have an obligation to charge sales tax, a company must first have a physical nexus with that state. States intentionally define *"nexus"* broadly and vaguely so as to not limit their tax base; however, *"nexus"* generally means that you have an employee or office within that space or make continued, habitual, and repeated visits to that state. As states have become more revenue-hungry, they continue to expand what constitutes nexus, including the use of independent agents or affiliates. When entering into sales contracts with consumers from a new state, a company should perform an analysis to determine if it has in fact created nexus within that state and is then required to potentially charge and remit sales tax.

As an example, a company that is headquartered in New York, with an employee in California, and a co-location data center in Illinois, will be considered to have nexus within New York, California, and Illinois. Assuming no other physical activities (*including trade shows, sales demonstrations, server hosting, among others*) within any other states, the company does not have to even worry about sales tax in the other states since it has no nexus in those stats. The buyers, however, will have to consider if responsible to remit any use tax in those states.

## SALES TAX

Once a determination has been made if the company has nexus within a state, it must then consider the taxability of the transaction. As stated prior, each state has a different definition of what is considered a taxable sale. Technology companies are often either in the software (*including SaaS and physical software*) or service areas. For most states, delivery of physical prewritten software constitutes a sale at retail, and sales tax is due. Some states have determined that SaaS, electronic delivery of software, and electronic goods are also sales at retail and therefore subject to tax (*New York, for example*), while others have ruled that SaaS does not constitute a taxable transaction. Technology companies also need to look at the *"true object"* test, to determine what it is they are actually being compensated for. In some cases, companies may be using technology to deliver an information service, which can be taxable or non-taxable depending on the state, delivery method, and underlying content.

As general advice, the company should examine the contracts for what is being provided and then perform research on the taxability of that transaction. Often this will require some judgment in determining the true object of the service and how it fits into current tax law. Luckily, continued uncertainty has led more states to issue rulings on how certain technologies should be taxed, giving more clarity than even a few years ago.

Let's go back to the example of the company that has nexus in New York, California, and Illinois. Assume that the company has determined that its service is ultimately an information service facilitated by technology, and the information is not considered private in nature. As such, sales to New York are subject to sales tax, but sales in California and Illinois are not. Additionally, the company has a customer in Florida, but does not have nexus there, so no further determination is required as without nexus it is not required to charge sales tax there.

## REGISTRATIONS & FILINGS

Once a company has determined that it's subject to sales tax in a given state, it will then need to register as a sales tax vendor within that state. As an aside, companies will also need to register for authority to do business with the secretary of state for any state in which it has nexus. These registrations usually require some pedigree information, such as **Employer Identification Number (EIN)**, name, name of officers and registered agents (*official in state addresses if no office in the state*), along with statutory filing fees.

Once registered, the company begins to collect sales tax as a *"trust fund,"* money collected on behalf of a governmental agency. Each state has a different filing frequency for sales tax. Most of them will start out quarterly and then either move to monthly or annually, depending on sales levels. The returns should be filed in a timely manner and remitted with payment of the collected trust funds. Sales tax is based on the end user location, not the location of the company, and the end user pays it. Sales tax is not an additional cost of doing business since it is ultimately the consumer who pays the tax.

With the barriers of doing business in states lower than ever, particularly for technology companies, understanding sales tax obligations is a difficult but necessary task. The laws can be very complex due to their sheer volume, and these laws frequently change as states seek new ways to generate revenue. Failure to collect sales tax can result in taxing authorities holding the seller and its officers personally responsible, and can be a major risk and burden if not handled properly. Companies should take the time to understand and address this issue now, before it becomes too impractical to do so.

# 10 HELPFUL TIPS FOR TECH STARTUPS

There is no doubt that creating a tech startup is a monumental undertaking. Even if you have a new and innovative idea, translating this idea into a successful business requires a great deal of hard work and sacrifice. Although there are no shortcuts to accomplishing your goal, there are a few important points to keep in mind that can help make the process run more smoothly.

## 1. BE PATIENT

Taking an idea all the way from the drawing board to the production line is a lengthy and arduous process. Everyone wants to become the next Google or Facebook and many startups attempt to expand quickly to gain a leg up on their competition. Rushing to expand quickly, however, is far from the best strategy. Building a successful startup takes time, and there is usually no way around this. It is vital that you take your time to learn your strengths and develop a proper strategy. Any expansion should be done in carefully measured steps with sufficient funding at every level.

## 2. PROTECT YOUR IP

The core of any successful startup is its IP, or intellectual property, which is any idea that can lead to financial gain. Because these ideas are what the startup relies on to generate revenue, it is essential that they are protected at all times. The simplest and most reliable way to guard your IP is to file a patent. Filing a patent should be done as soon as possible to give you exclusive rights to the benefits of your ideas. Another important item to consider using is a confidentiality agreement. Requiring potential investors or employees to sign confidentiality agreements will help prevent them from disclosing sensitive information about your ideas to the public. Finally, trademarking your company's name is another significant step in protecting your business. Similar to a patent, a trademark will prevent your company's name from being used by others. Trademarking your business will allow you to build a recognizable brand around your name.

## 3. DEVELOP AND IMPLEMENT A BUSINESS PLAN

Without a focused and well thought out business plan, failure is inevitable. A properly developed business plan should aim to answer one key question: *How will my business become profitable?* When answering this question, it is important to keep in mind that not all good ideas are good businesses. Successful businesses are those that know what they do best and do it well. In order to determine exactly what it is that you do best think about the need you are targeting with your idea and why you can fulfill this need better than your competition. A well-designed business plan should also be flexible and adaptable to prepare your startup for the future. It should be thought of as a living and breathing document that requires regular updates to remain relevant in an ever-changing world. *Lastly,* be sure to actually implement your plan. Do not simply draft a business plan and file it away. An excellently developed plan is useless if it is not followed.

## 4. SECURE A SOURCE OF FINANCING

Running a startup will be costly and securing a source of financing is essential to keeping your business afloat. Start small and ask friends and family for funds to launch your business. Explore alternate options, such as research grants, to secure initial capital. As your organization grows, be prepared to give up equity. Know all of your options, including private equity, angel investors, and venture capitalists. When raising capital, however, you must remain wary. Develop a realistic valuation for your company and stick to it. It's your business so don't sell yourself short. Presenting to potential investors may feel like an intimidating task but, as long as you develop and practice your pitch the presentation will run smoothly. Focus your pitch on which problems your technology addresses, how you provide solutions to these problems, what market you plan to pursue, and how you will counter your competitors.

## 5. SPEND WISELY BUT DON'T PENNY-PINCH

During the startup phase of your organization there's no doubt that money will be tight. Therefore, it's important that you control your costs and prioritize your spending. Focus your spending on the core resources that support your organization such as finance, accounting, and legal professionals that help manage your finances and protect your IP. Offer attractive compensation packages to hire valuable employees but avoid bloated salaries. Use stock options to bolster salaries and keep your employees invested in the company's success.

## 6. BUILD A SOLID FOUNDATION

The foundation of your startup should be one of the first areas of focus. This infrastructure comprises the core departments of your startup such as legal, accounting, IT, and HR. Building up these departments will help ensure that your business runs smoothly. Legal will defend your valuable IP, accounting will manage your cash flow, IT will keep all of your devices connected, and HR will ensure that you hire employees that are the best fit for your company. And all of these professionals will keep you out of legal trouble. Remember, creating an efficient and scalable infrastructure from the start is much easier than overhauling a barebones system when your company's growth is exploding.

## 7. HIRE AND RETAIN THE RIGHT EMPLOYEES

When hiring employees it is vital to think of them not as just your workforce, but instead as a resource. Research typical pay rates for your industry and ensure that you compensate your employees fairly. Make an effort to hire employees that believe in your vision and are not simply in it for the money. Reward employees that fit your organization's culture and fire those poisonous employees that don't respect the company vision. At such an early stage of your business' life cycle you can't afford to waste resources on lost causes.

## 8. BE OPEN TO FEEDBACK

Because it's your business, it can be difficult to hear criticism of your ideas, but it's absolutely vital that you seek out the opinions of others. Working tirelessly on a project you value may lead you to overlook certain weaknesses or flaws of your ideas. Surround yourself with other visionaries, not just *"yes men,"* so that you can assess your ideas and gain new perspectives. Remember to take a step back once in a while and listen to your employees for new ideas or a new spin on yours. Also, keep in mind that as a startup you're likely new to your industry. Even if you're off to an early success, don't become overconfident and close-minded. Always remain open to new points of view.

## 9. KEEP CUSTOMERS COMING BACK

Customers are another source of valuable feedback. Making sure that customers are satisfied is crucial to building a successful startup. Talk to customers to learn what characteristics of your idea are valuable to them and focus on building up those aspects. Ask them what they care about, how your company's idea solves their problems, and how much are they are willing to pay for a solution. It may be painful to hear but, you need to listen to your customers' complaints. Fixing the flaws in your ideas that customers point out will ensure that your product remains relevant and competitive. Keeping your customers content is the first step in turning them into your raving supporters. If you can build a loyal fan base around your product you'll save marketing dollars and gain a huge competitive advantage.

## 10. THE PERSONAL SIDE

By now, you certainly realize that building your startup will require some personal sacrifices. You'll need to live leanly while you grow which may mean leftovers for lunch and Saturday nights at home. If you believe in your vision though, these sacrifices will be worth it. Remember to take things step-by-step to avoid burning out. If you begin to feel overwhelmed, slow down and take some time to breathe. Remember your passion for your idea, stay motivated, and try to have fun. Don't forget why you started this business: *to solve a problem bigger than yourself!*

# THESE NETWORKING BLUNDERS CAN COST YOU

Successful entrepreneurs know that having a strong network behind them is critical. Done well, networking is hard but important work. There's no shortage of mixers, parties, meetings, and lectures to attend, and most professionals, business owners, and job seekers have no problem showing up. But too many people think they've done their job just by walking in. They pass the time by traveling in a pack with the people they came with, lingering by the food table, or checking social media on their phone. At the other extreme are those who interrupt conversations and make requests of VIPs without offering anything in return. And perhaps the most common category includes those who actually make meaningful connections at the event, but think their work ends when the event does.

Networking advice abounds in blogs and books, but my role as chair of the Startups practice at Campolo, Middleton & McCormick and my own experience as an entrepreneur have given me a front row seat to some of the most common networking mistakes entrepreneurs make. A sampling of the most critical:

## 1. NETWORKING ONLY WHEN YOU NEED SOMETHING

The process of building a powerful network can (*and should*) span a career. If you don't put yourself out there until you need something, you'll just be trying to make up for lost time. Even the most unseasoned entrepreneurs who aren't expected to bring in business yet should be encouraged to start developing their networks by attending events and joining organizations, and be armed with the funds to do so. No matter your current situation, start now.

## 2. ATTENDING EVENTS THAT DON'T WORK FOR YOU

It's never a bad thing to check out a new group, and be on the lookout for different ways to expand your network. Don't waste time on events or organizations that you're just not getting anything out of. Too many professionals keep going back to the same groups because they were a good fit for a friend or cater to people in their industry. Sometimes those things just aren't enough. Don't set a firm deadline by which your involvement needs to translate into a new client, but frequently take stock of your activities to see if you're building valuable connections. If not, it's time to move on.

## 3. ACTING SELF-IMPORTANT

When you're in a networking situation, *are you elbowing your way into conversations and talking about yourself or your business the entire time?* If so, you're not alone. Most people love to talk about themselves. Spin that around to your advantage by letting others do the talking and being a good listener. Based on what you've learned, consider if you have anything to offer them—for example, a contact you can introduce them to. Let the relationship grow from there. People like to return the favor when you've helped them out.

## 4. ACTING LIKE YOU'RE NOT IMPORTANT

On the flip side, there are those who act as though they don't deserve to be there or aren't good enough to rub elbows with the crowd at an event. You don't want to be too pushy or self-focused (*see #3*), but if you don't believe you have anything to offer, the people you're speaking to won't think so, either.

## 5. FORGETTING THE FOLLOW-UP

This mistake is perhaps the biggest and most common. Leaving an event with a stack of business cards isn't going to get you anywhere if you never follow up with those people again. A quick email or call to schedule a follow-up coffee or lunch, or perhaps a meeting to introduce them to someone who would be a worthwhile connection for them, should be the next step—promptly. Connect with the person and/or their company on social media. It seems obvious, but time and time again, entrepreneurs squander valuable relationships by not putting in the effort to keep them up.

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McWilliams has vast experience working with startup, early stage and mature technology companies; this experience combined with his understanding of tax law allows for specialized advice in the areas of tax compliance, controversy, international taxation, and state and local taxes for these companies.


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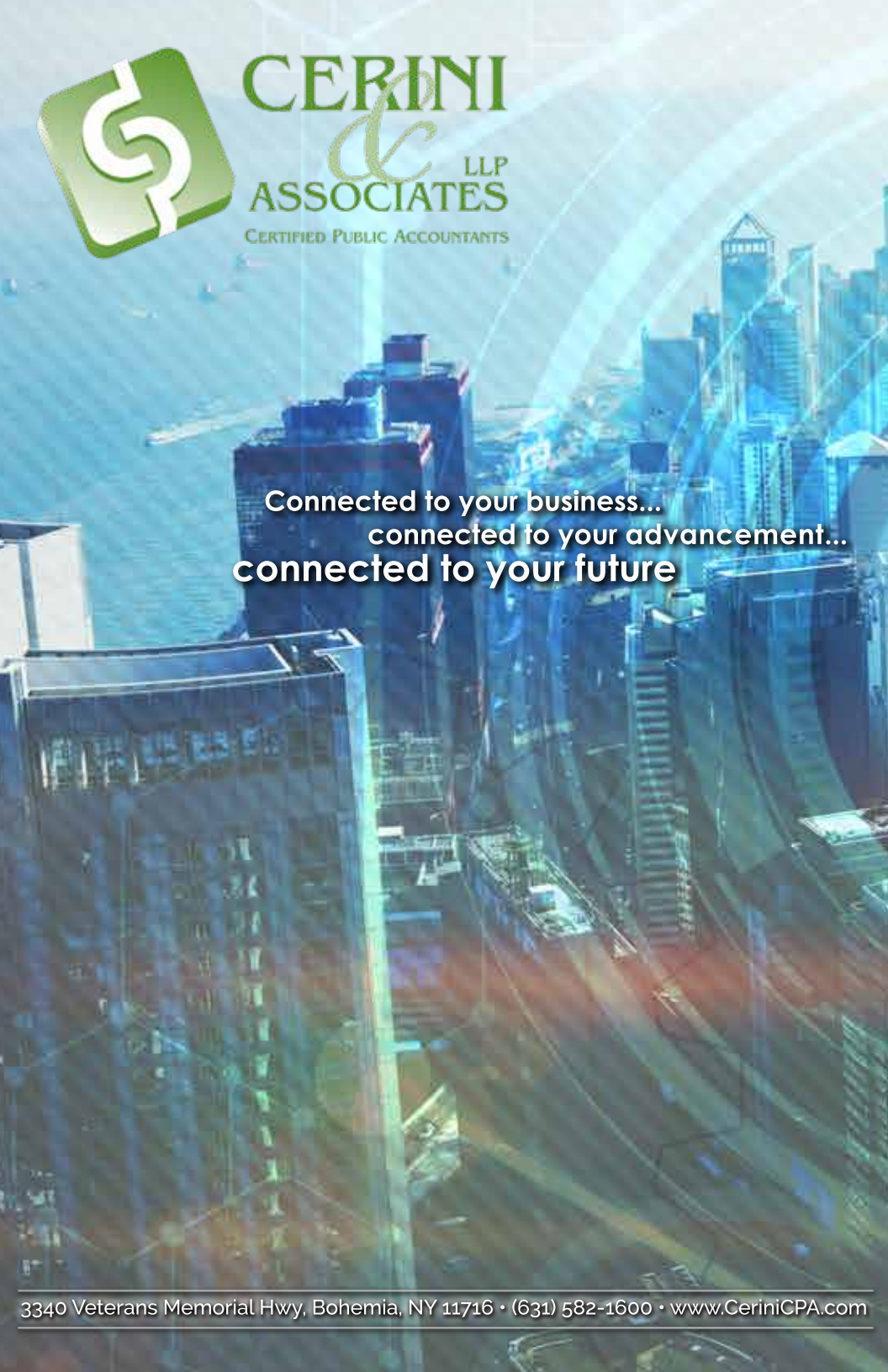
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