Prime

The 7 key considerations for tech start-ups choosing a business structure | by Marc Peskett

SME Advisory

Most tech start-ups have aspirations of building a scalable business with global reach and Many Make early Mistakes that can easily be avoided.

For most tech businesses, initially, the focus is firmly on technical development to produce a useful and saleable product, device, app, software or tool. In these early stages of development, implementing a robust commercial structure might seem like a distraction that is best left until later. Get the technology right first, then figure out the detail when the business actually makes a sale, starts to expand or grow and operational issues become more necessary to address.

Unfortunately relegating your business structure to the bottom of the list of priorities can also cause problems down the track. Once you get started, tax and legal impediments can make it complex and costly to change your structure mid-course.

Let me give you an example. Most aspirational tech start-ups will engage in several capital raising rounds with a number of different investors. Typically, each round will attract its own terms and conditions, with an overriding Shareholders Agreement that binds these terms. These terms will typically include the type of shares that have been issued by the business; which entity the shareholder owns shares in; preference rights; anti-dilution and right of first refusal clauses.

With legally binding agreements in place, it can be complex to change a structure without affecting these shareholder rights. In most cases, every shareholder would need to agree before this change can happen.

Also if the restructure isn't implemented carefully, you could also find it triggers an unwanted tax liability for the business or its shareholders on the unrealised value of the entity. This could happen at a point in time before the business has actually generated any surplus cash to pay for these liabilities.

Avoiding these situations makes it important to think ahead and obtain advice early. Establish a structure that is both robust, but flexible enough to support the business and its activities now and into the future, and you'll have invested some effort up front that provides many positive returns to you over the life of the business.

Here are my seven key considerations for tech start-ups choosing a structure:

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1. Tax is an important consideration, but it should not be the key driving force for choice of structure.

You need to consider how the structure is taxed on its profits, how your personal income and drawings are treated and how any capital gain that you may make on the sale of the business will be treated, in order to maximise your return upon sale. But tax is only one consideration in the mix, along with the other commercial needs and objectives you have for the business as outlined below.

2. Investor Friendly and Ready. It's important to think about the funding needs of the business and your options for obtaining funds.

For businesses that intend to raise capital through private equity, the structure needs to be both investor friendly and investor ready. Almost all professional investors will only invest in a business with a corporate structure, as it has clearly defined shareholders rights. They also have the assurance of a corporate structure being governed by the corporations act and administered by the Australian Securities and Investment Commission (ASIC).

Another funding option might be government grant programs. In many instances, only companies are eligible to claim or apply for these programs, which can provide substantial amounts of cash to support business activities.

The Research and Development Tax incentive is one example. I have seen many start-ups set up complex trust structures to achieve a great tax outcome, which is only useful if and when the start-up gets to a taxable position. But in the meantime, the structure is unappealing to investors and limits their ability to access Government funding, which affects the opportunities, growth and value of the business.

3. Intellectual Property Protection. Central to the core of most tech start-ups is some form of valuable Intellectual Property (IP) that has been developed.

In the early stages, this IP will usually be developed in a structure which then becomes the trading entity. The IP could be protected by a patent, or other rights such as a copyright, but also needs to be protected from the trading and operating risks that arise, when the business starts dealing with the outside world.

This is usually achieved by having the IP in a separate structure to the trading entity.

The IP entity will then license the use of the IP to the trading entity. Forward planning is also needed when deciding which entity will own IP, as moving IP from one entity to another can create legal problems and where the IP has value, you could also find you crystallise an unwanted tax liability as well.

4. Employee Share Schemes. At some stage most start-ups will want or need to issue shares or options to their staff.

At some stage most start-ups will want or need to issue shares or options to their staff. Employee share schemes in this country are an important tool for cash strapped start-ups to motivate, reward and retain key employees. Make sure your structure and supporting investor and shareholder agreements will allow for employee equity to be issued, in the right entity. A corporate structure is generally required for employee share schemes.

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5. Commercial Acceptance and Operations.

It's important to have a structure that is commercially acceptable and easy to deal with. This is not so important if you're dealing with individual consumers, but if your customers are other businesses or Government departments in particular, they can have strong opinions about the type of business structures they will engage with.

Most government departments for example, will only deal with corporate structures. Banks, insurers, landlords and other third parties important to the operation of your business can also treat businesses differently based on their structure.

You also need a structure that is scalable and can grow with your business and its changing needs. Once again, this comes back to planning for the future and choosing a structure with flexibility to accommodate different opportunities the business might face, as it evolves through various stages of growth and maturity.

6. Internationalisation. Many tech businesses are now doing business overseas.

They either establish operations in overseas countries or relocate their head office and entire business overseas, in order to expand and raise capital. If this is a likely outcome for your business, then you need to put in place a structure that allows for this at the outset. where you're considering relocating your head office or setting up a holding company overseas, then this is usually best achieved by implementing what is referred to as a "corporate flip up" structure.

7. Exit. A successful exit is what most aspiring tech start up's strive for.

Having a structure that provides choice and flexibility as to how you might sell the business is important. In the case of a company structure you have a choice to sell the shares in the company or the business separate from the structure. Each option has different commercial and tax implications and both are important to your investment in the business and that point in time when you eventually want to realise and extract some or all of it.

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