

Paying the Founders: It's Not As Simple As Writing A Check

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STARTING UP: *Practical Advice for Entrepreneurs*

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A few days ago Victor Capatil; a fellow who invests in early-stage companies, called me with comments on my last BBJ column, "Beware capital-gains gift."

"You really should tell entrepreneurs how to pay themselves," V.C. insisted. "It's a tough issue, believe it or not, that frequently screws up an investment."

What's V.C. talking about? The entrepreneur just writes a check to him/herself, right?

Unfortunately, it's not that simple. If you don't do it intelligently, you could wind up with tax problems, miss an opportunity to put more money in your pocket and jeopardize your chances of raising equity financing.

Let's assume you've recently incorporated a new venture. While you develop your new product, you plan to live off some personal savings, etc. Why not put some money into your corporation so that its balance sheet looks better, and then pay yourself a "modest" salary?

Why not? Because by doing so, you will expose your money to creditors and have to pay income and employment taxes on your compensation. And, unless we're talking about a large investment, who in the world is going to be fooled by a "stronger" balance sheet in your start-up venture?

Why not just put your money into the company and then "borrow" it when you need to meet personal obligations? You don't pay income taxes when you borrow money, do you? Well, not usually. But if the loan is in lieu of salary, your friendly IRS agent may see it otherwise.

We recommend that you don't put your money into the new venture. Instead, keep most of the money in your personal account and draw on it to meet your personal needs.

For example, one of our start-up ventures consisted of four people - each of whom agreed to invest \$25,000 in their new venture. Two of the founders were engineers who would quit their jobs immediately and develop the product over the next eight months; the other two were financial and marketing types who would keep their day jobs and join the venture full time when the product was ready.

Instead of having each of them put the \$25,000 in and then pay part of those funds out in salary to the two engineers, we suggested that each of them invest \$5,000 in equity. The financial/marketing founders would each retain their \$20,000 portion and use it to "pay" themselves, outside of the corporation, a salary-equivalent of \$2,500 per month for eight months. In that way they would not pay income taxes on their "salary," and they, as well as the corporation, would avoid FICA and FUTA taxes.

While it's true that, if the venture succeeds, the financial/marketing founders will eventually get their \$20,000 loan back and the engineer-founders won't, these entrepreneurs anticipated that the difference could be made up with a bonus or other compensation adjustment later on.

That idea of paying a bonus in the future leads me to another issue: Even if you don't have a lot of money to invest in your business, don't assume that you can't pay yourself. Sure, you say, I'll just pretend I'm IBM's Lou Gerstner and tell the company that if they want my services they'll have to pay me big time. Come on, Joe, where am I going to get the money to pay me what I'm worth?

Well, I didn't mean that you would get paid today; but what about getting paid in the future for what you do during the lean start-up years? Many founders fail to distinguish between the ideas and technology that they bring to a new venture, on the one hand, and the time, talent and effort they invest in getting the new venture off the ground. Many founders and investors lump those two separate "functions" together under the name "sweat equity" - i.e., the founders get their stock for bringing their bundle of ideas/technology to the table, while the investors get their stock for the cold hard dollars they supply. But where is it written in stone that the founders should not be separately compensated for their time/talent/effort - i.e. "sweat?"

Which brings me back to my conversation with Victor Capatill. V.C. and other investors will tell you that they want to see their invested dollars going into growing the business, and not into paying past expenses and salary. In fact, that philosophy is in the interest of the founders also; presumably, a dollar invested in growing the business will pay off with a larger "pie" later on. However, if a founder presses the investors a little, he or she may find that the real issue is simply that they don't want their invested funds to be paid out now.

V.C. tells me that he is not at all averse to recognizing the prior "sweat" of the founders - if that recognition is in the form of "deferred compensation." If the founders accrue (but don't pay) a reasonable salary on the balance sheet for the period prior to the first outside investors, V.C. and other investors may not have a problem with the deferred compensation being paid out in future years.

One final note of caution: If you decide to take the deferred compensation approach, be sure to check the current tax and accounting rules. For example, if a deferred compensation arrangement is "vested," the IRS will require FICA and FUTA taxes to be paid today on the deferred amount for past services - even if you won't get your money until later. In the past, that sometimes was not a problem, because FICA taxes were not paid on salary above the FICA base. But since 1993 the health portion of FICA is required to be paid on all compensation.

Or, you might opt to take your deferral in the form of a subordinate note, a note with warrants, or some sort of redeemable equity security. Know that those all have tax issues associated with them. Also, you may want to consider obtaining life insurance to cover the deferred compensation, as well as to protect the value of your equity interest.

Finally, a word to the wise: Don't go crazy with deferred compensation. Your balance sheet will become important if you seek bank financing. And, at some point, potential investors will balk at an extravagant amount.

What's really at issue is that you have an obligation to understand your investors' viewpoints, and beyond that, your challenge will be to manage their perceptions of why you should get your founder's stock and deferred compensation.

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