ONLINE BUSINESS

Where, Oh, Where to Begin

BY BO BURLINGHAM @BOBURLINGHAM

Trying to decide what business to go into, and other perplexing problems.

Inc **Query**

This month we have another bevy of beautiful questions about choosing a business, getting the right corporate tax status, creating an online presence, and sharing equity with a salesperson.

Gearing Up to Take the Plunge

I am a 24-year-old student at one of the top 10 business schools in the country. I'm also working in a strategic consulting firm, which is fine, but my heart isn't in it. Hard as it is to turn your back on a more or less secure job in corporate America, I know I won't be satisfied until I have my own business. The problem is, I'm a bit confused about where to begin. For one thing, I can't figure out the best way to leverage my skills. In fact, I'm not sure how to identify entrepreneurial opportunities in general. Any advice would be appreciated. --Mike

You have good reason to feel confused, Mike. "I think it's real tough for anybody to go out and start a business in a world he knows nothing about," says Tom Golisano, the founder and CEO of Paychex Inc., an $870-million payroll-processing and human-resource-services company based in Rochester, N.Y. "My advice to Mike would be to find a job in a dynamic industry and then to be constantly on the lookout for opportunities within that industry. He can do a lot of investigation, research, and soul-searching without financial consequences as long as he maintains his job. In the process, he'll acquire in-depth knowledge of a particular industry, which will make him far more qualified to compete in it than if he had just walked in blind.

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"By the way, that's pretty much what I did before I started Paychex. I spent two years selling accounting machines, which were used, among other things, to process payroll. Then I spent two more years in sales and sales management for another payroll-processing company. Those experiences were critical to the success of Paychex -- because I knew there was a market for what I was trying to sell. That was a big advantage."

Trapped by the Tax Code

I am the operations manager of a small publishing company and the son of the entrepreneur who started the business. We will do approximately $2 million in sales this year. Lately, we have worked hard to streamline our operations, creating systems and procedures that have made us more efficient and profitable.

As a result, we have run into a problem. While we'd like to keep as much money as possible in the business to hedge against a downturn, we find that we're hindered by our corporate form and tax status. As a C corporation, we have to pay taxes of 39% on the portion of our annual earnings between $100,000 and $335,000. In addition, our inventory situation requires us to go from cash to accrual accounting this year, which makes it tough to switch to another corporate form. We could reduce our earnings by buying things, but spending money for its own sake runs counter to our culture. What would you do in this situation? --Jason

We'd get a very good accountant, Jason. Your business could be a case study in the importance of including tax planning as part of your overall business planning. You evidently came up with a good plan for your business, but you neglected to get good advice about the tax implications of achieving your plan. It also sounds as if you made a mistake in selecting the corporate form you adopted.

"The general rule is that a privately held business with a small number of shareholders should be an S corporation unless there are compelling reasons to have another corporate form," says Tom Feeley, founder and principal of Feeley & Driscoll PC, a Boston-based accounting firm that counts several *Inc* 500 companies among its clients. "I doubt that Jason and his father would have these concerns if their company were an S corporation, and it would have no trouble switching to S status if it were already on an accrual basis.

"But because the company has to convert from cash to accrual this year, it finds itself in a trap. The change will create on paper a lot of additional income. That income can be phased in over four years, but if the company switches to S status, it will incur an additional tax on the phase-in. The alternative is to wait for four years and then become an S corporation.

"There are strategies the company might use to make the S selection sooner without incurring a huge tax liability, but Jason and his father need help in exploring those options. They should find an accountant who has experience dealing with small, growing privately held companies. As for other private companies set up as C corporations, they should look into the advisability of becoming S corporations now -- before they fall into the trap Jason has found himself in."

Why Go on the Net?

My wife and I own a $3.5-million company that supplies and installs cabinets and provides finish-carpentry services. We have a reputation in Oregon and Washington as being the best company to work for and with. We're currently installing all the finish carpentry at the Seattle Seahawks' new stadium, and we have many other prestigious jobs. We're thinking about setting up a Web site, but I'm not sure how it would help us beyond being an electronic brochure. Am I missing an opportunity? --Bill

For advice on this one, Bill, we turned to Pud of F***edcompany.com. Those familiar with his site -- they number in the millions -- know that he has chronicled just about every mistake companies have made on the Net. If you read last month's profile of him (" Lucrative Expletive"), you also know that he started out as a Web developer and a very successful one at that.

"As a Web developer, I could come up with all kinds of ideas for stuff Bill could do with his site," Pud told us. "That would be good for me and bad for him. For example, he could have an extranet where customers could look up the status of their projects, see all the billing and expenses, and so on. That's classic. You spend a ton of money on stuff you can't charge for and that most people don't care about anyway. Not only is the site costly to build, but it's even costlier to maintain. So you lose your shirt.

"Bill should stick with the electronic-brochure concept. Yes, you've got to have a Web presence or your business looks really out of it, but remember the new rules of the Internet: Don't give stuff away, and don't try to fill a need that doesn't exist."

A Piece of the Action

My wife and I started a marketing-communications business about five years ago. Most of our people work on a contract basis. One of them, an account manager, has been especially great. Aside from working well with clients, she has tremendous knowledge of electronic media production and media buying -- both

wildly profitable services we didn't offer before she came. Last December she helped us land our first really big account with a national company. That has created an opportunity for us to grow the business significantly and (belatedly) start building our nest egg for retirement.

So here's the issue: the account manager is now interested in becoming an employee with a small ownership stake. My wife and I like the idea. We can see her helping us become much more profitable in the future. Our plan is to have a probationary period, after which we'd get a valuation done and allow the account manager to buy up to 15% of the stock. If we decide not to proceed after the probationary period, she could stay on as an employee or we'd go our separate ways.

It seems simple enough to me, but our accountant, our lawyer, and many of our friends are extremely negative about the idea. We could use advice from someone who has experience with sharing equity. --Richard

The person you're looking for, Richard, is Jack Stack of SRC Holdings (formerly Springfield Remanufacturing Corp.), who started the company in 1983 with 12 other managers as shareholders. Today SRC has 804 employee-owners. "I wouldn't offer equity to anybody just for landing one big account, especially if all your eggs are in that basket," he says. "On the other hand, I wouldn't mind offering equity as a reward for taking risk out of the business by bringing in three or four more customers and diversifying the customer base.

"Say the goal is to have no single account represent more than 40% of total revenues. I'd have a plan for letting the account manager buy up to 10% of the equity based on progress toward that goal. I'd start by giving her 5% in stock options at the current appraised value. Then I'd let her buy another 2.5% when the largest customer accounted for 60% of revenues, and another 2.5% at 40%. I'd hold an additional 10% of the equity in reserve for new employees who come in later.

"I'd also let the account manager know you'll give her a bonus to pay for the stock, provided the sales she brings in allow you to improve your margins. Otherwise, she might be tempted to go for low-margin sales. Just make sure that the margin improvement is enough both to cover the bonus and to increase your bottom line.

"As for the lawyer and the accountant, they're paid to give you safe answers. Write down their concerns and address them in the shareholders' agreement. There are some dangers, but you can anticipate them. The most important thing is to have a buyout clause that protects the company if one of the shareholders cashes out."

The Whole New Business Catalog

Where, Oh, Where to Begin
With a Little Help from My Friends
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Board Stiff

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@BOBURLINGHAM

BO BURLINGHAM | Staff Writer

Burlingham joined Inc. in 1983. An editor at large, he is the author of Small Giants. Burlingham is also the co-author with Norm Brodsky of The Knack; and the co-author with Jack Stack of The Great Game of Business.