Small computers and small investors

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ABSTRACT

The availability of low-cost hardware and the activity of turnkey developers has significantly expanded the number of potential computer users. Limited capital has been a major inhibiting factor in the growth of this marketplace. This paper proposes a method whereby small investors can use leveraged leasing to inject the capital necessary for expansion in this area. Investors may, after weighing potential risks and costs, obtain income as well as significant tax advantages. Developers can grow without requiring additional capital. Small end users can lease rather than purchase. Computer professionals can invest money, as well as time and effort, in their profession. Included is an analysis of a typical procedure for creating such an arrangement. Financing, tax analysis, contracting, and negotiations are specifically addressed.

The computing industry today is in a position similar to that of the automobile industry shortly after the turn of the century. We are witnessing a transition from an industry with its emphasis on technological marvels to a business based upon mundane, even household, uses of computing equipment. At the same time, we are observing the commencement of a transformation in the type of people involved in computing and the data processing industry. We are seeing the decline of the "computer priesthood" and the rise of a new entrepreneurial class. That is: the people who work with computers are beginning to invest their money, as well as their time and knowledge, in their profession.

Technological change is, of course, an important factor in this shift. For example, in the past few years we have seen the minicomputer market boom, the microprocessor market develop, and the leading edge of the personal computing phenomenon appear. So-called "mini" computers now have up to one megabyte of memory, and support data base management systems, high-level languages, and a wide variety of applications software. At the same time, the cost factors involved are dropping rapidly.

We could expect this change to be even more explosive were it not for certain limiting factors. Two of these are of immediate relevance. First, many of the developers of small systems (as well as potential users of these systems) have definite credit limits. Difficulty in obtaining capital, coupled with the traditional unavailability of leasing arrangements for small developers and users, inhibits growth to a considerable degree.

The second factor of importance is that the manufacturers of most of the smaller systems which would be suitable for financially limited users are incapable of providing "hand holding." Programming and maintenance support usually come from "local" system developers and turnkey system suppliers who are also limited financially.

This paper will present one approach which may be useful in surmounting these problems. It attempts to bring together the small investor, the OEM or turnkey system developer, the manufacturer of minicomputer systems, and potential users who, either through limited credit or concern over lack of expertise and technological obsolescence, do not or cannot purchase their data processing equipment. Essentially, this approach involves the use of leveraged leasing by an investor, who purchases a small computer and then leases it to a minicomputer turnkey system developer, who in turn will lease to an end user. Many variations of this arrangement are possible, but for discussion purposes, let us consider the ramifications of the set of agreements just described.

It should be noted at the outset that this opportunity may prove particularly attractive to small investors having a computer background, as they are in a unique position to spot opportunities for development. That is, they are likely to be aware of software/hardware package developments which are not effectively marketed due to a lack of financing. Furthermore, they are often able to understand and evaluate both the technological and marketing aspects of such a situation. Finally, it should be stressed that the benefits of this approach can apply to people who have a relatively small amount to invest and who are on fixed incomes. Tax shelters, for instance, are available to investors at any level, not just to the "wealthy."

Before looking at the specific procedures to be followed in setting up an arrangement of this type, let us quickly review some of the benefits, risks, and costs which are likely to be encountered.

There are two major benefits for an investor in a situation such as the one under consideration. First, and most obviously, there is an opportunity for income. Such income can provide a very useful supplement to a basic salary, since once the arrangements have been made, the expendi-
ture of time by the investor is minimal. Second, a wide variety of tax shelter benefits may exist, depending upon the particular financial situation of the individual investor. It should be reiterated that these shelters are available to any investor, no matter what his level of financial involvement. Finally, although it was pointed out earlier that such an opportunity would be particularly appealing to an investor with a computer background, such knowledge is not essential. There is no requirement for particular expertise, nor for a large overhead. Of course, this is an advantage for the developer as well, since it considerably broadens his potential range of investment sources.

For the developer, it provides an opportunity to obtain the financing necessary to fully develop and effectively market his system. This is often quite difficult for the small software developer acting alone. Even for those already established as business entities, this method can provide an opportunity for expansion, after capital credit limits have been reached.

There are also benefits for the users. First, such an arrangement permits a user with a limited availability of capital to lease instead of purchase. It also provides flexibility, and enables the first-time user to get into data processing without having to acquire an in-house staff. It will also benefit all users in the long run, by encouraging the development of a greater number and wider variety of user-oriented software/hardware packages.

Finally, there will be benefits to the computer industry as a whole. It may be expected that increased investments at this level would encourage a considerable growth in the total number of users, particularly at the small end of the spectrum. It should furthermore encourage broader diversification within the manufacturing and software industries. Last, there should be an increase in the development of new application areas, since the availability of financing will encourage such development by individuals who were previously discouraged by the difficulty of financing the start-up of a small business.

As in any investment situation, there are risks and costs which must be recognized and evaluated. The costs are fairly obvious: some capital must be provided; in the case of leveraged leasing (that is, leasing by an investor who puts up a part of the capital outlay—say 20 percent to 30 percent of the total cost—and finances the remainder) there will be interest charges; there will be fees for the professional services of accountants, financial advisors and attorneys; and finally, there will of course be taxes to pay.

The major risks may be listed rather simply. They are: default by one of the parties; changes in tax regulations after the investment has been in place for some time; a failure on the part of one or more of the suppliers; problems of coordination between the parties involved; a failure to address all potential problems during the negotiating phase; to some extent, technological obsolescence (though this is less troublesome where the investor has a computer background); and unanticipated steep rises in costs (for example, for insurance or maintenance).

Let us now consider the basic procedures which would be followed in arranging an investment package of this type. It should be pointed out at the outset that as such an arrangement is developed, all of the factors should be individually explored, evaluated, and agreed upon in negotiations, prior to executing any contractual commitments relative to any single part. Furthermore, of necessity, the procedures outlined here are only general in nature. Each particular situation, depending upon the status of the individuals and parties involved, will require considerable "tailoring." It will be necessary in almost every case to obtain financial, tax, accounting, and legal advice prior to making any commitments.

The following analysis will be based upon a hypothetical situation structured as follows:

Two system specialists have jointly developed an industry application package to operate upon a particular computer configuration. They have entered into an OEM agreement with the manufacturer of that hardware. They are prepared to undertake the marketing and maintenance of this package if they can obtain financing through a lease-back arrangement. The parties involved therefore will be the minicomputer manufacturer, the software developers, the investor, and the end-user.

The first step will be to consider financing arrangements. Naturally, it will be necessary for the investor to put up at least a portion of the purchase price in cash. Generally speaking, the minimum percentage will be ten percent, with more common figures ranging from 20 percent to 30 percent. Thus, for a typical minicomputer system in the $50,000 to $100,000 range, the investment amount required might be between $5,000 and $30,000.

In shopping around for a financing organization, the most important considerations on the part of the investor will probably be the interest rate and the schedule of payments. For tax reasons the length of the financing term may also be important. In some cases, it may be possible for the investor to take advantage of an OEM discount which would be available to the developer. For example, a developer might be able to purchase from the manufacturer at a discount and resell to the investor at that discount price. The financing organization may then take into account the market value (or list price) of the system in determining the percentage of the total investment which they will finance. Thus, an investor with ten thousand dollars might be able to obtain a $100,000 system if he received a 20 percent discount and put up his $10,000 in cash, thereby needing to finance only $70,000 of a $100,000 purchase.

Of course, the business form of the investor (sole ownership, partnership, corporation) may affect the financing. Almost certainly the financing organization will require some sort of security interest, such as a mortgage on the property. They may also require the investor to assume personal liability for the loan.

Once the availability of financing has been determined, and the various options identified, it is necessary to undertake a tax analysis. As was mentioned earlier, such an analysis will vary with the financial status and requirements of the investor. There are in any case a number of general
considerations which should receive attention in such analysis. (Keep in mind that this is an area in which expert advice is almost essential, since the complexity and rapid change of tax regulations makes effective analysis by lay people extremely difficult.)

There are several sources of potential tax advantage in an arrangement such as the one under consideration. First, where a portion of the purchase price has been financed, it may be possible to deduct the interest paid on the amount financed. Such a deduction is generally available, although there are certain significant conditions under which it may be limited.

Second, the Tax Reform Act of 1976 extended the availability of the investment tax credit. This credit, which is also subject to certain limitations as to amounts and availabilities, is a one-time credit of up to 10 percent of the total purchase price of the hardware. This credit is particularly advantageous if the investor has an income peak which he wishes to offset in the year in which he acquires the equipment.

Third, the equipment purchased (and in some cases a certain amount of associated software) may be depreciated. There are basically two types of depreciation applicable to personal property such as a minicomputer. The first is regular, or "straight-line" depreciation; the second is accelerated depreciation, which may take any of several forms. This is an area of considerable complexity, since accelerated depreciation is often treated as a tax preference item, and since determination of useful life can be a significant factor.

Finally, deductions are allowed for any legitimate business expenses and taxes (such as property and sales taxes) which may arise in the various transactions.

There are, on the other hand, some possible tax liabilities which must be evaluated. First, such an investment will in most cases generate income which will be subject to tax. Second, the equipment (and possibly the software in some jurisdictions) may be subject to property taxes or sales taxes. Of course, as was indicated, these taxes may be a source of deductions, but they must nonetheless be paid.

Third, an improperly structured transaction may result in the recapture, at a future date, of taxes avoided through accelerated depreciation. Finally, if the arrangement is not set up properly, the Internal Revenue Service may find that the transaction is in fact a sale rather than a lease, and certain leasing advantages or tax advantages (e.g., the investment tax credit) may be diminished or lost.

The next step is the contracting phase. It is particularly important to remember that the purpose of a contract is not merely to serve as a tool for the resolution of disputes, should they arise. Rather, its most important purpose is to serve as a medium for the formalization of all the aspects of the working agreements between the parties. In a situation such as the one presently being considered, there will be multiple contracts. There will be contracts for: the original sale of the equipment; the sale of the hardware by the developer to the investor; the lease from the investor back to the developer; the lease from the developer to the end user; financing arrangements; insurance coverage; and maintenance. Each agreement will have some unique requirements. There are, however, some general principles which may be applied in all of them.

One of the most important considerations in structuring the agreement of sale is insuring that advantage is taken of all possible tax benefits. Specifically, responsibility for sales taxes, and pass-through of investment tax credits (if appropriate) should be delineated. Contracts of sale should also spell out very clearly the responsibilities of the parties, and any liabilities which may attach. For example, the time at which title transfers should be specified. Responsibilities for maintenance, delivery costs, and documentation should be enumerated. Warranties should be clearly specified, as should effects of liens, and provisions for failure to deliver.

It is often desirable to include guarantees of performance and certifications of originality. Of course, detailed hardware specifications and configurations should be attached to, and made part of, the formal agreement.

As the owner of the equipment, the investor must enter into certain peripheral agreements himself, and must insure that other parties also fulfill their responsibilities in such matters. This is particularly true in the case of insurance and maintenance agreements.

Of course, the investor himself will be responsible for any financing contracts which he may enter into. These agreements will probably provide a security interest in the equipment on the part of the financing organization, and therefore may have to be referenced in other contracts.

The next agreement which should be considered is the lease to the developer. It should be pointed out that it is quite possible for a developer with adequate capital to form his own organization to purchase the computer, and then to lease that computer to a separate business entity of which he is a part, which would handle marketing and maintenance. A common arrangement in this regard is for a group of developers to form a partnership, which purchases equipment for lease to a corporation, the stock of which is held entirely by the same individuals who comprise the partnership.

Other contract provisions should define responsibility for the installation of the system, and for the maintenance of the software and the hardware. Provision should be made for upgrading hardware and software components, for insurance coverage, and for payment of other costs such as shipment. The lease contract, like those relating to the original sale, should address any applicable warranties, including guarantees of performance, guarantees of originality, and provisions for the lessee to be an attorney-in-fact of the lessor in relationship to the vendor, in order to obtain advantage of any vendor warranties.

It is also desirable for the lessor to insure that he receives treatment at least equal to that accorded any other customer of the developer. It is quite possible that the developing organization may also develop or market other software packages, and deal with other investors. It is, therefore, important for each investor to insure that a more profitable arrangement does not displace him in leases to end users.

It is also essential to consider what happens upon the termination of the agreement. There are three types of
termination which must be dealt with. The first of these is a temporary termination. This occurs in the case where an end user (for any reason) terminates his agreement. The responsibilities of the developer as lessee and the investor as lessor must be clearly specified, particularly with regard to who will bear the burden of carrying the cost of the equipment until it can be replaced in another end user organization. Second, provisions must be made for the orderly, planned termination of the contract at the end of its specified term. This will be influenced considerably by tax considerations. For example, the lessee may wish to have the option to purchase the equipment at the end of the lease.

Finally, attention must be directed to the eventuality of an unexpected business termination by any of the parties. This is particularly important in the case of the developer, since the termination of the developer as a business entity could severely affect the investor’s ability to continue supporting installed end users. This is especially true in the case where the investor is not knowledgeable in the computer field, or where the investor does not have the time to market and maintain the equipment. At the very least, provision should be made for escrow of the source code and the documentation of the application programs.

In the case where multiple business entities are involved (that is, where the developing organization is a subsidiary of a larger organization), it may be desirable to include provisions for cross guarantees.

In addition, there are a number of other standard contractual provisions which should be considered. Among these are limitations on assignments, methods of payment, and availability of financials of all the parties. These provisions can be fully explained and evaluated in each situation by legal counsel.

While the investor may not have a direct relationship with the third party or end user, he nonetheless should be aware of the contractual arrangements between the lessee and the end user, especially with regard to costs and liabilities in the event of termination. This agreement should clearly specify the rights, relationships, and responsibilities of the parties in such a way that the investor is reasonably protected.

The final area for consideration is that of negotiations. This is the phase in which all of the factors are put together into a workable arrangement. Prior to entering into negotiations, it is particularly important for each party to specify formally its own requirements and objectives. This is the part of the process in which the use of specialists such as CPA’s or attorneys is particularly important. It should be reiterated that the entire package should be formalized before commitments are made with respect to any portion of it.

Just as in good system design, it is important that negotiations be both comprehensive and formal. Each factor should be carefully considered, and a specific agreement reached as to the terms relating to that factor. These should then be documented fully.

At first glance, such a project may seem somewhat complex. It is in fact a unique opportunity which is quite feasible if approached with care and understanding. The members of the data processing community are presented with an opportunity both for the development of new systems and markets, and for personal investments in a familiar business environment. By being watchful for development opportunities; by being aware of one’s own resources, situation, and objectives; and by following the basic procedures outlined herein relative to financing, taxation, contracting and negotiation, small investors, system developers, and end users can obtain significant financial and business advantages.

The utilization of this approach can considerably increase the availability of computer systems to a wide variety of business organizations. It offers significant opportunities for entrepreneurs, developers, and investors. Finally, it provides a unique means whereby computer professionals can invest in their own profession.