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LETTER FROM THE EDITOR

Welcome to the *Entrepreneurial Executive*. We are confident that this volume continues our practice of bringing you interesting, insightful and useful articles by entrepreneurs and scholars.

The *EE* is an official journal of the Academy of Entrepreneurship®, a non-profit association of scholars and practitioners whose purpose is to advance the knowledge, understanding, and teaching of entrepreneurship throughout the world. It is our objective to expand the role of the *EE*, and to broaden its outreach. We are interested in publishing articles of practical interest to entrepreneurs and entrepreneurial scholars, alike. Consequently, we solicit manuscripts from both groups.

The *Entrepreneurial Executive* is funded by the proceeds of membership dues and conference registration fees at Academy of Entrepreneurship® and Allied Academies meetings. We do not receive funding support from any university or agency. We encourage readers to become members of the Academy and to attend conference meetings in the spring and the fall. Upcoming conferences are announced on the Allied Academies home page: www.alliedacademies.org, as well as information about the organization, its affiliates and its journals. In addition, instructions for submitting manuscripts are displayed on the home page.

The manuscripts contained in this issue were double blind reviewed by the Editorial Board members. Our acceptance rate in this issue conforms to our editorial policy of less than 25%.

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EXPORT CONTROLS AND THEIR EFFECT ON BUSINESS OPERATIONS

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ABSTRACT

Federal laws restricting exports of goods and technology have been in existence for decades. These export control laws and regulations are designed to restrict exports of goods and technology that could contribute to the military potential of U.S. adversaries, prevent proliferation of weapons of mass destruction, and protect the U.S. economy by promoting trade goals. In the wake of 9/11, attention to export controls has significantly increased due to heightened concerns about national security, including concerns about terrorism and leaks of technology both to economic competitors and enemies of the United States. Export controls present unique challenges to employers and businesses because they require that particular care be taken with respect to the dissemination of information abroad, as well as to foreign nationals working in the Unites States. Compliance risk assessment is critical for businesses, as the potential penalties for violations are substantial. The purpose of this paper is to provide some basic information to identify how and when export control issues may arise, and to assist in understanding how these laws may affect normal business activities.

INTRODUCTION

Despite his testimony that he did not intend to break the law, plasma physicist J. Reece Roth, a retired 70-year-old University of Tennessee professor, recently was convicted of exporting scientific know-how in violation of federal law. Roth had worked on U.S. Air Force contracts with a Knoxville technology company, Atmospheric Glow Technologies, to develop plasma-based guidance systems for unmanned surveillance vehicles (drones). Roth improperly shared sensitive information with his students from China and Iran and traveled overseas with electronic versions of that material on his computer. The Knoxville company and another scientist also pled guilty to related charges. Enforcement authorities have warned that there is heightened interest from China and the Middle East in obtaining this type of information from seemingly benign settings such as a university. Roth will be sentenced in early 2009 and may face more than a decade in prison (Johnson, 2008).

Clearly the professor was not a spy engaged in espionage activities, so what law did the professor violate? Federal laws regulate the distribution of strategically important products, services and information to foreign nationals and countries in the interest of our national security. The primary agencies responsible for implementing and managing these export control laws, which apply to the transfer of physical items, information, and services, are the Department of State through its International Traffic in Arms Regulations (ITAR) administered by its Directorate of Defense Trade Controls (DDTC) and the Department of Commerce through its Export Administration Regulations (EAR), administered by its Bureau of Industry and Security (BIS). Additionally, the Department of Treasury enforces economic sanctions and trade embargoes, which prohibit transactions with countries, entities and individuals subject to boycotts and trade sanctions, through its Office of Foreign Assets Control (OFAC).

Such a regulatory scheme must balance the desire for free trade and globalization needed for economic growth with the need for maintaining national security (Juster, 2001).While the federal government historically has treated the enforcement of international trade and security restrictions seriously, the war on terrorism, coupled with the strengthening and commensurate enforcement of corporate ethics and liability laws, are responsible for an increased intensity of monitoring efforts (Clark & Jayaram, 2005).

This regulation of exports, including technical data, is of particular interest to small business owners. According to the Intuit Future of Small Business Report, (Intuit, 2008), small businesses are continuing to drive U.S. economic growth and by 2018, almost half of them will be involved in global trade. Nearly 97 percent of all businesses that export goods are small to medium sized organizations, representing 30 percent of the total value of U.S. goods exported globally. Considering that more than 70 percent of the world's purchasing power, and 95 percent of its population, are outside of the United States (Hernandez, 2007), it is readily apparent that opportunities to market products globally are great. Yet, while military and government officials are expected to be vigilant in safeguarding weapons and sensitive data, and to be punished for their failures (Tyson & White, 2008), it is less intuitive that such expectations and ramifications may also exist for business owners. This paper will discuss the significance of this export control regulatory scheme to business operations and the responsibility of businesses in pursuing global markets while preserving national security interests.

INTERNATIONAL TRAFFIC IN ARMS REGULATIONS (ITAR)

The Department of State has the responsibility for the control of the permanent and temporary export and temporary import of defense articles (such as weapons and technical data) to foreign countries to prevent the development of arms and weapons capabilities. The Arms Export Control Act (AECA) charged the President to "control the import and the export of defense articles and defense services and to provide foreign policy guidance to persons of the United States involved in the export and import of such articles and services" (22 U.S.C. § 2778 (a)(1), 2006).

The Act provided for the promulgation of implementing regulations, or the ITAR (International Traffic in Arms Regulations), which are also administered by the State Department. These regulations primarily address the importation and exportation of defense related trade and technology transfers. The Arms Export Control Act, which the professor in the introduction violated, provides that the "Secretary of State, in consultation with the Secretary of Defense and the heads of other appropriate departments and agencies, shall establish and maintain, as part of the United States Munitions List (USML) a list of controlled items, which under the regulations require a license prior to exportation" (22 U.S.C. § 2297 (a), 2006).

The twenty-one categories of USML items are inherently military in character, and include equipment, software, and military electronics, as well as chemical and biological agents (22 C.F.R § 120.10, 2006). The classification is based upon the *capability* of the product to be used for military purposes, and not whether or not the intended use of the article after export is for military or civilian purposes (Liebman & Lombardo, 2006). There is also a catch-all category entitled "Miscellaneous Articles" for items that are not specifically enumerated in other categories of the USML, but which have substantial military application and have been designed or modified for military purposes, including technical data and defense services that are directly related to the defense articles specifically enumerated (Liebman & Lombardo, 2006).

As originally enacted, the AECA imposed licensing and registration requirements only on individuals engaged in the business of manufacturing, exporting, or importing USML articles and services; however, Congress expanded the category in 1996 to include persons engaged in the business of brokering activities with respect to the manufacture, export, import, or transfer of USML articles and services, defining "brokering activities" as "the financing, transportation, freight forwarding, or taking of any other action that facilitates the manufacture, export, or import of a defense article or defense service" (22 U.S.C. § 2778(b)(1)(A)(ii)(II), 2006). Persons now potentially subject to licensing and registration requirements include "any U.S. person, wherever located, and any foreign person located in the United States or otherwise subject to the jurisdiction of the United States" (22 C.F.R. § 129.3(a), 2006). The regulations now detail the requirements for the registration and licensing of brokers as well (22 C.F.R §§ 129, 2006).

All exports of USML items and technical data, such as blueprints, drawings, plans, instructions, diagrams and photographs, must be licensed by the Directorate of Defense Trade Controls (DDTC) unless expressly exempted. (22 C.F.R §§ 123 & 125, 2006). DDTC regulates items in order to "advance national strategic objectives and U.S. foreign policy goals through timely enforcement of defense trade controls and the formulation of defense trade policy" (DDTC Mission Statement, 2006). To this end, the DDTC adjudicates license applications for exports of defense articles and services, handles matters related to defense trade compliance and enforcement, and provides reports to Congress and the public on defense trade.

The Arms Export Control Act directs that

> [D]ecisions on issuing export licenses under this section shall take into account whether the export of an article would contribute to an arms race, aid in the development of weapons of mass destruction, support international terrorism, increase the possibility of outbreak or escalation of conflict, or prejudice the development of bilateral or multilateral arms control or nonproliferation agreements or other arrangements (22 U.S.C. § 2278 (a)(2), 2006).

As part of the regulatory scheme designed to provide the government with necessary information on who is involved in defense manufacturing and exporting activities, companies that produce, furnish or export items requiring a license must register with the Office of Defense Trade Controls and pay an annual fee. Even manufacturers that do not export are required to register and pay the fee, as "registration provides important information on the identity and location of defense companies and enforces on their management a large degree of responsibility for compliance with export controls laws" (22 C.F.R § 122, 2006). Registration is a precondition for the issuance of any license or other approval for export. All exports of USML items and technical data, such as blueprints, drawings, plans, instructions, diagrams and photographs, must be licensed by DDTC unless expressly exempted.

DDTC maintains a fully electronic defense trade licensing system, "D-Trade," in order to facilitate the process (D-Trade Information Center, 2006). As part of the Public Service Plan within DDTC's mission, the agency strives to take initial action on license applications within ten working days of receipt, and responds substantively to inquiries within forty-eight hours of receipt (DDTC Public Service Plan, 2006). Licensing forms are available for the permanent export, temporary export and temporary import of covered items and services. In addition to the resources available on the State Department's website for licensing compliance, the Society for International Affairs, Inc. (SIA), a volunteer, non-profit, educational organization, hosts a forum for the exchange of information related to export and import licensing, which covers licensing issues pertaining not only to the Department of State, but also to the Departments of Commerce, Defense and Treasury.

Exemptions from the license requirement, and hence governmental control of dissemination, include items already in the public domain, fundamental research and teaching (for example, information and technology taught in university catalogue courses). In other words, it is not a crime to transmit information abroad that is expressly exempted from the statutory prohibition. "Public domain" means information which is published and which is generally accessible or available to the public" by one of several listed means, such as through:

- sales at newsstands and bookstores
- subscriptions available without restriction
- second class mailing privileges

- libraries open to the public or from which the public can obtain documents
- patents available at any patent office
- unlimited distribution at a conference, meeting, seminar, tradeshow or exhibition, generally accessible to the public, in the United States
- public release, and
- fundamental research in science and engineering at accredited institutions of higher learning in the U.S. where the resulting information is ordinarily published and shared broadly in the scientific community

(22 C.F.R § 120.11, 2006)

The public domain limitation applies to *technical data*, not to items such as firearms or weapons on the USML, as the government may still preclude their export, even though such items might be available to the public in the United States (Lee, 2003). In other words, actual shipments of USML items will *always* require a license.

As noted, the ITAR exempt fundamental research which is generally classified as being in the public domain. It is defined in the regulations as basic and applied research in science and engineering where the resulting information is ordinarily published and shared broadly within the scientific community, as distinguished from research the results of which are restricted for proprietary reasons or specific U.S. Government access and dissemination controls. The regulations provide that university research will not be considered fundamental research if it, or its researchers, accept restrictions on publication of scientific and technical information resulting from the project or activity, or if the research is funded by the government and specific access and dissemination controls protecting information are applicable (22 C.F.R § 120.11(8), 2006).

While industry-sponsored research at an institution of higher education may qualify for this exemption, care should be taken in defining proprietary rights. For example, if a laser manufacturer reviews research prior to publication in order to ensure that patent and other proprietary rights will not be compromised, or reserves the right to withhold publication if the results are undesirable, then the research no longer qualifies for the fundamental research exception under the ITAR (Rege, 2006).

Export means the actual sending or taking a defense article or technical data out of the United States in any manner, (except by a person merely traveling abroad whose personal knowledge includes technical data), or transferring its registration, control or ownership. An *End Use Certificate* must accompany each bid submitted by a prospective purchaser. The End Use Certificate indicates the purchaser's intended disposition of the property and the property's intended end use. The DDTC's *Blue Lantern Program* monitors the end-use of commercially exported defense articles, services, and related technical data subject to licensing in an effort to deter diversions to unauthorized end-users, to aid in the disruption of illicit supply networks, to make informed licensing decisions, and to ensure compliance with the AECA and the ITAR. End-Use

Reports on checks performed under the Blue Lantern program are available annually on the State Department's website (End-Use Reports, 2008).

Additionally, export also means what is commonly referred to as a "deemed export," that is disclosing (including oral or visual disclosures) any defense article or technical data to a foreign person, or performing a defense service on behalf of, or for the benefit of, a foreign person, whether in the United States or abroad (22 C.F.R. § 120.17, 2006). A foreign person, or foreign national, means any natural person who is not a citizen, a lawful permanent resident (green card holder), a refugee or alien granted asylum, as well any foreign corporation, business association, partnership, trust, society or any other entity not incorporated or organized to do business in the United States (22 C.F.R § 120.16, 2006). The conclusion drawn under the deemed export rule is that ultimately the foreign national will return to the home country, and the information will then be *deemed* exported.

The regulation of deemed exports can catch the unwary business by surprise. For example, as applied, a deemed export of information that would require a license could include a foreign national witnessing any demonstration or briefing, or using controlled equipment in a corporate research laboratory, U.S. employees of foreign subsidiaries sending non-public information (i.e., information not in the public domain) to themselves via email while overseas, and industrial scientist-employees of corporations submitting articles for peer-review abroad, if the corporation retains proprietary rights to keep the information private (Rege, 2006). Thus, a disclosure of controlled technical information to a foreign national in the U.S. or abroad without a license could occur by seemingly benign transmissions, such as through:

- communication by fax
- telephone discussions
- e-mail communications
- computer data disclosures
- face-to-face conversations
- training sessions
- tours involving visual inspections
- conferences and meetings
- transfers of equipment abroad
- sharing/shipping encryption source code

As Professor Roth can attest, the failure to obtain the appropriate license can result in substantial criminal penalties. Any person or entity who *willfully* violates the regulations, or willfully, in a registration or license application makes any untrue statement of a material fact or omits a material fact, may be fined up to $1,000,000 for each violation and/or imprisoned up to ten years (22 USC § 2778(c), 2006). Civil penalties may be assessed up to $500,000 for each violation as well (22 USC § 2780, 2006). Additionally, violators may be debarred from exporting defense

articles and technical data, or from furnishing defense services for which a license or approval is required, for an appropriate period of time as determined in State Department proceedings (22 C.F.R § 127.7, 2006). The State Department encourages the voluntary disclosure of violations by firms, and may take such disclosures into account as a mitigating factor in determining the imposition of administrative penalties (22 C.F.R § 127.12, 2006).

EXPORT ADMINISTRATION REGULATIONS (EAR)

To counter the proliferation of weapons of mass destruction, the EAR restrict the involvement of "United States persons" anywhere in the world in exports of foreign-origin items, or in providing services or support that may contribute to such proliferation. Unlike the ITAR, which only regulate articles, technology and services related to defense, the EAR are concerned with "dual use" items, that is, goods and technology that are primarily commercial, not military in nature, but which may have a dual militaristic use, such as lasers, global positioning systems and computers. For example, the EAR require licensing for encryption items, because they "can be used to maintain the secrecy of information, and thereby may be used by persons abroad to harm U.S. national security, foreign policy and law enforcement interests" (5 U.S.C. § 742.15, 2007).

The EAR are issued by the United States Department of Commerce, Bureau of Industry and Security (BIS) under laws relating to the control of certain exports, re-exports, and activities (15 C.F.R. § 730.1, 2007). The mission of BIS is to "advance U.S. national security, foreign policy, and economic objectives by ensuring an effective export control and treaty compliance system and promoting continued U.S. strategic technology leadership" (BIS Mission Statement, 2006). In addition, the EAR implement anti-boycott provisions that prohibit specified conduct by United States persons that has the effect of furthering or supporting boycotts fostered or imposed by one country against another country that is friendly to the United States (15 C.F.R. § 730.1, 2007).

The majority of exports that require a license under the EAR are controlled pursuant to the Commerce Control List (CCL), which is administered by the Department of Commerce (15 C.F.R. § 774.1, Supplement No. 1, 2007). Many items are not on the CCL, or, if they are on the list, require a license to only a limited number of countries. License requirements under the EAR are dependent upon an item's technical characteristics, the destination, the end-user, and the end-use. The exporter must determine whether or not an export requires a license. When making that determination, consideration must be given to:

- what is being exported
- where it is being exported
- who will receive the export, and
- purpose for which the export will be used

(*Introduction to Commerce Department Export Controls*, 2007)

BIS maintains the CCL, which includes items (commodities, software, and technology) subject to its authority. The CCL categorizes the products and related technology that it covers into 10 topical categories, numbered as follows:

0 - Nuclear Materials, Facilities and Equipment and Miscellaneous
1 - Materials, Chemicals, "Microorganisms," and Toxins
2 - Materials Processing
3 - Electronics
4 - Computers
5 - Telecommunications and Information Security
6 - Lasers and Sensors
7 - Navigation and Avionics
8 - Marine
9 - Propulsion Systems, Space Vehicles and Related Equipment

(15 C.F.R. § 738.2(a), 2006)

Within each category, items are arranged by group. Each category contains the same five groups. Each group is identified by the letters A through E as follows:

A - Equipment, Assemblies and Components
B - Test, Inspection and Production Equipment
C - Materials
D - Software
E - Technology

(15 C.F.R. § 738.2(b), 2006)

Any product or technology that is subject to the EAR that does not fall under one of the ten specific CCL categories will fall into EAR 99. For example, bullet-proof windshield glass exported separately from a vehicle is on the control list if it is for vehicles designed or modified for non-combat military use, but it is classified as EAR99 No License Required (NLR) if it is for civil automobiles designed for the transportation of passengers and marketed through civilian channels (BIS *Advisory Opinions,* 2006). Licenses are not required for products or technologies in this category except in a few circumstances, such as for exports to certain countries where such exports have been embargoed (Liebman & Lombardo, 2006).

In order to classify an item against the CCL, an exporter should begin with a review of the general characteristics of the item to be exported. This will usually guide the exporter to the appropriate category on the CCL. Once the appropriate category is identified, the exporter should match the particular characteristics and the functions of the item to a specified Export Control Classification Number (ECCN). Within each group, individual items are identified by an ECCN. A

brief description is provided for each ECCN. There is also information relating to "License Requirements," "License Exceptions," and "List of Items Controlled." The CCL identifies all possible reasons for control, in order of restrictiveness, and the extent to which each applies. The accompanying country chart identifies almost every country in the world and contains licensing requirements based on destination and reasons for control (15 C.F.R. § 738, 2006).

By identifying the ECCN for a proposed export, and cross-referencing that number to the country chart to which the item is to be exported, the exporter will be able to discern whether or not a license is needed (15 C.F.R. §§ 738.1-738.4 & Supp. 1, 2007). In addition to this licensing matrix, other restrictions based on embargoes may also apply to exported dual use goods. For example, the Department of Commerce will deny applications to export items subject to the EAR to entities sanctioned by the Department of State pursuant to statutory authority , such as Cuba, Iran, Iraq, Rwanda, and North Korea (15 C.F.R. § 744.19, 2007). If exporters are unsure about whether or not a commodity is subject to the jurisdiction of the Commerce Department's export licensing authority, or if they are unsure of the item's classification, then they may make a Commodity Jurisdiction request or a Commodity Classification request to the BIS, as appropriate, to determine the ECCN or if a license is needed.

Some transactions may be covered by one or more of the license exceptions to the EAR such that no license is required (15 C.F.R. § 730.7, 2007). Exceptions from the license requirement may include such things as the use of certain temporary exports up to one year, which may include beta test software or commodities necessary for news-gathering purposes. More importantly, no license is required for the export of public information, that is information which is "generally accessible to the interested public in any form," such as information in periodicals, books, print, electronic, or any other media available for general distribution (5 C.F.R. § 734.7(a), 2007). There is also an exception for "basic and applied research in science and engineering, where the resulting information is ordinarily published and shared broadly within the scientific community," as distinguished from "proprietary research and from industrial development, design, production, and product utilization, the results of which ordinarily are restricted for proprietary reasons or specific national security reasons" (5 C.F.R. § §734.8(a), 2007). Since much research in business will be of a proprietary nature, it will be subject to the EAR's licensing requirements.

Like the ITAR, the deemed export principle applies under the EAR as well. For example, technology or software is "released" and deemed to be an export if it is the focus of or if it falls within one of these three broad definitions: visual inspection by foreign nationals of U.S.-origin equipment and facilities, oral exchanges of information in the United States or abroad, or the application to situations abroad of personal knowledge or technical experience acquired in the United States (15 C.F.R. § 734.2(b)(3), 2006). The EAR also restrict technical assistance by U.S. persons with respect to encryption commodities or software (15 C.F.R. § 730.5(d), 2007). Other examples of more traditional exports under the EAR include the return of foreign equipment to its country of origin after repair in the United States, shipments from a U.S. foreign trade zone, and the electronic transmission of non-public data that will be received abroad (15 C.F.R. § 730.5(c), 2007).

Further, both the EAR and the ITAR also apply to *re-exports*. Re-exports are commodities, software, and technology that have been exported from the United States to be exported again from the country to which the U.S. export was consigned (15 C.F.R. § 772.1, 2007). Some re-exports may go to destinations which qualify for an exception from licensing requirements depending on the countries involved, whereas others may not (15 C.F.R. § 730.5(a), 2007). *Deemed-re-exports* are also possible. For example, if technical data is exported to a U.S. subsidiary in Germany, and that technology is shared in Germany with a foreign national from India who works for the subsidiary, then a subsequent license for that disclosure might be needed, depending on the classification of the data. Moreover, in some cases, authorization to export technology from the United States is subject to additional assurances that items produced abroad that are the direct product of that technology will not be exported to certain destinations without authorization from the BIS (15 C.F.R. § 730.5(b), 2007).

As a result, in additional to traditional export transactions, certain activities should be monitored carefully such as:

- visits of foreign nationals
- purchasing and dealing with foreign/international vendors
- shipment of equipment and its end use
- collaboration with foreign nationals within and outside of the U.S.
- travel outside the U.S. by employees
- access to facilities and equipment by foreign national employees
- transmission and receipt of information subject to licensing

Like the ITAR, sanctions under the EAR can be substantial. Convicted defendants may be fined not more than five times the value of the exports or re-exports involved or $50,000, whichever is greater, or imprisoned not more than five years, or both. Corporate criminal penalties for "willful" violations shall be a fine of not more than five times the value of the export or re-export involved or $1,000,000, whichever is greater; and, in the case of an individual, shall be fined not more than $250,000, or imprisoned not more than 10 years, or both. There are also administrative sanctions for civil violations that include monetary penalties, denial of export privileges, and exclusion from practice. Items transferred in violation of the EAR are subject to being seized, as are the vessels, vehicles, and aircraft carrying such items (15 C.F.R. § 764.3(c)(2)(i), 2006).

BIS strongly encourages disclosure to the Office of Export Enforcement (OEE) if a person believes that he or she may have violated the EAR, or any order, license or authorization issued under the EAR. Voluntary self-disclosure is a mitigating factor in determining what administrative sanctions, if any, will be sought by the OEE (15 C.F.R. § 764.5, 2006). The weight given to voluntary self-disclosure is solely within the discretion of the OEE, and the mitigating effect of voluntary self-disclosure may be outweighed by aggravating factors. Voluntary self-disclosure will not prevent transactions from being referred to the Department of Justice for criminal prosecution

(15 C.F.R. § 764.5(4), 2006). If a person learns that an export control violation of the EAR has occurred or may occur, that person may notify the OEE, which is a division of the U.S. Department of Commerce, Bureau of Industry and Security. Notification of violations of anti-boycott provisions of the EAR should be sent to the Office of Anti-boycott Compliance, which is a separate division of the U.S. Department of Commerce, Bureau of Industry and Security.

OFFICE OF FOREIGN ASSETS CONTROL (OFAC)

The third category of export controls is administered by the Office of Foreign Assets Control (OFAC), which is located in the U.S. Department of Treasury. This office enforces economic and trade sanctions in furtherance of foreign policy and national security. The Treasury Department administers economic sanctions against a variety of countries, including Burma (Myanmar), Cuba, Iran, Sudan, Libya, North Korea, and Syria, which prohibit economic interaction with the target country, as well as any dealings with designated individuals (e.g., foreign nationals) and entities, such as parties affiliated with a sanctioned country or government, parties connected to terrorist activities, and parties connected to the international narcotics trade (Clark & Jayaram, 2005).

Additionally, the property of certain persons or entities from other countries with questionable domestic or foreign policies, such as The Congo, Belarus, The Cote d'Ivoire, Zimbabwe and the Balkans, may be frozen from time to time, and trading privileges suspended.

Economic sanctions can be violated by U.S. firms in several non-obvious ways, for example, by

- purchasing an approved foreign firm's assets, which happen to include supply contracts with a sanctioned entity
- investing in a joint venture if other participants include sanctioned parties or sanctioned entities
- acquiring even a minority interest in the shares of an approved company that engages in significant sales to a sanctioned customer

(Clark & Jayaram, 2005)

Of course, licenses may be obtained from OFAC to engage in a transaction that otherwise would be prohibited. There are two types of licenses: a general license, which authorize a particular type of transaction for a class of persons without the need to apply for a license, and a specific license, which is a written document issued by OFAC to a particular person or entity, authorizing a particular transaction in response to a written license application (31 C.F.R. § 501.801, 2006). For example, the Clinton Administration authorized commercial sales of food, medicine, and medical equipment to Iran on a case-by case basis to approved buyers with certain payment restrictions (Donboli & Kashefi, 2005).

Compliance with the regulations enforced by OFAC can be challenging because they are broad, ambiguously drafted, and often interpreted by the Treasury Department in a far-reaching and undocumented manner (Clark & Jayaram, 2005). Since there is no list or set of regulations issued by OFAC comparable to the USML or the CCL, but only various provisions in the Federal Code detailing sanctions against specific target countries or entities, transactions with any of these targeted countries, or other entities identified as proliferation risks, should be handled with extreme caution (Liebman & Lombardo, 2006) as noncompliance with trade sanctions can prove to be costly.

Again, fines for violations often can be substantial. Depending on the program, criminal penalties can include fines ranging from $50,000 to $10,000,000 and imprisonment ranging from 10 to 30 years for willful violations, while civil penalties range from $11,000 to $1,000,000 for each violation. Most recently,

- Vesper Corporation remitted $23,800 to settle allegations of violations of the Cuban Assets Control Regulations and Iranian Transactions Regulations
- Tyco Valves & Controls Middle East, Inc., remitted $450,905.50 to settle allegations of violations of the Iranian Transactions Regulations
- EMD Chemicals, Inc., remitted $8,250 to settle allegations of violations of the Iranian Transactions Regulations
- Encore Medical, L.P., successor by merger to Chattanooga Group, Inc., remitted $3,241.20 to settle an alleged violation for disregarding licensing requirements for the export of physical therapy equipment to Iran

(U.S. Department of Treasury, 2007).

In determining a settlement amount or penalty assessment, OFAC considers whether or not the institution made a deliberate effort to conceal the violation, along with any useful enforcement information provided during an OFAC audit, investigation, or penalty proceeding (Wray & Hur, 2006).

COMPLIANCE PROGRAMS

The maintenance of compliance programs by exporters are essential in order to insure not only that their exports are properly licensed, but also that controlled items, technologies, and software are not diverted to prohibited end users or end uses (Export Management, 2007). To this end, it is imperative that a company know its customers because the Department of Commerce has the authority to make individuals and companies ineligible to export materials from the United States, as well as to receive exports from the United States. BIS maintains several lists that should be consulted, which identify prohibited parties (Lists to Check, 2007), such as the *Denied Persons List*, consisting of parties denied export privileges (Denied Persons List, 2007) and the *Unverified List* which includes names and countries of foreign persons previously parties to a transaction for

which BIS could not conduct a pre-license check or a post-shipment verification (Unverified List, 2007).

In addition to the lists maintained by BIS, the Treasury Department's Office of Foreign Assets Control maintains the *Specially Designated Nationals List* (SDN) (Specially Designated Nationals List, 2007), consisting of front companies, parasitical entities, or individuals determined to be owned or controlled by, or acting for or on behalf of, targeted countries or groups, as well as "Blocked Persons," who are specially identified individuals, such as terrorists or narcotics traffickers. United States entities are prohibited from engaging in any transactions with them, and must block any property in their possession or under their control in which they have an interest.

The State Department maintains a list of parties who are barred under the ITAR from "participating directly or indirectly in the export of defense articles, including technical data or in the furnishing of defense services for which a license or approval is required" (22 C.F.R § 127.7, 2006). The list is available on DDTC's website. Transactions with parties on these lists should raise a red flag under exporter compliance programs. Software packages, such as *Visual Compliance*, may be purchased to screen for restricted parties and countries, and to determine if export licenses are required (e-Customs, 2008).

Compliance with this complicated maze of export regulations can be daunting for corporations, particularly small companies. Costs include the expenses involved in inventorying the equipment and technology subject to the ITAR and the EAR, as well as applying for export licenses and deemed export licenses for foreign national employees and affiliates (Findley, 2006). Additionally, export controls can complicate corporate transactions in several ways, for example, by:

- necessitating export licenses and other export approvals as well as the need for amended or new ITAR registrations which require government approval
- requiring notifications regarding certain types of corporate transactions involving ITAR-registered companies, and often State Department reviews of transactions to verify whether a party is a reliable exporter
- triggering more intensive scrutiny of compliance records in assessing whether the proposed transaction would threaten the national security, particularly with companies that generate sensitive export-controlled technology
- recognizing successor liability for export control violations committed by the acquired entity before the acquisition

(Clark & Jayaram, 2005)

DDTC admittedly applies the doctrine of successor liability to deter fraudulent restructuring designed to escape liability; for example, in 2003 Boeing Company paid $32 million to settle charges resulting from the provision to several Chinese nationals by Hughes Space and

Communications ("HSC," a subsidiary of Hughes Electronics) of controlled data on the failed launches of two commercial communications satellites mounted on Chinese-origin rockets, even though Hughes Electronics reserved liability for any pre-acquisition export violations in the sale of HSC to Boeing (Fellmeth, 2006).

Badway (2005) argues that the complex federal regulatory scheme puts American businesses, particularly small companies, which cannot afford the added expense of a staffed compliance program, at a competitive disadvantage with European competitors, which face less stringent controls and which can export dual purpose goods more promptly. This result is particularly disconcerting since the technologies the controls are attempting to protect to the detriment of American business, are often readily available elsewhere. More often than not the controls do little more than delay the inevitable exportation, while demanding excruciating attention to detail with respect to the license application (Klaus, 2003). Some authors, thus, advocate the elimination of the current transaction-based approval program in favor of regional or partner based trade agreements (Klaus, 2003; Bowman, 2004).

On the other hand, Sievert (2002) counters that simply because U.S. enemies can acquire articles from non-U.S. suppliers does not mean that U.S. companies should not be vigilant and exercise corporate responsibility in the exportation of goods and services in the interest of national security, although he admits that the current export control system could be relaxed somewhat "on shipments to firms, organizations, and nations that have demonstrated a history of using items for peaceful purposes and not transferring or re-exporting."

Nevertheless, for now, compliance programs and risk assessment plans are essential to U.S. businesses that deal in either dual use or defense related articles, technology or services. If companies fail to comply with export control laws, they subject themselves to severe monetary and criminal penalties, a time-consuming and costly defense, as well as potentially bad publicity, the loss of exporting privileges and debarment from government contracts. To insure compliance in this regulatory framework, companies should conduct self-audits based on the risk of non-compliance and develop internal controls, including an export control compliance manual that identifies red flags to consider for compliance-triggering transactions, such as shipping to new customers, sending data and specifications to suppliers, developing new product lines, hiring new employees, and sharing technology (Doornaert, 2005). Dunn (2005) developed a comprehensive model compliance program for companies that includes appropriate forms and lists specific red-flag alerts to heed at critical processing points.

Businesses must secure facilities and restrict access to technical information and items subject to control, particularly if foreign nationals are employed. Additionally, it is imperative that licensing documentation for all items subject to export controls and embargoes be maintained at a central repository (EAR 15 C.F.R. §762.2, 2006). The safekeeping of such records should be an integral part of any compliance program.

Another area of critical importance concerns laptop computers. As noted previously, encryption software may require a license for exportation under the EAR. For example, the

encryption technology employed in the Computrace software (Lojack for laptops) that many companies use to protect laptops from theft is controlled. Thus, if employees travel with their laptop computers to an embargoed country, such as China, not only the employees, but also the company, could be subject to substantial penalties for violating export control restrictions. Unless employees plan to sleep, eat, and shower with their personal computer, alternatives to taking a laptop should be seriously considered. The company could provide "travel friendly laptops" that do not have the encryption device, and develop a system for reserving such computers and monitoring their return.

At a minimum, businesses involved in covered transactions should coordinate compliance efforts by implementing an organizational a compliance regime. An *Export Control Review Committee* (ECRC) should be established to provide a communication plan to ensure compliance with federal laws and regulations related to export control. The committee should be chaired by the *Enforcement Officer* (EO) so that someone in the organization bears responsibility for compliance and oversight. The Committee should be charged with developing an *Export Control Plan* (ECP) to ensure not only that policies and procedures are in place at key points, but also to verify compliance with those established procedures and to evaluate the risk factors associated with the operation and functions of the business. Membership should include the following key personnel:

- Legal Counsel
- Internal Auditor
- Chief Operating Officer
- Chief Financial Officer
- Human Resource Director
- Purchasing, Receiving & Shipping Coordinator
- Safety Officer

With recommendations from the ECRC, the office of the EO should:

- Ensure compliance with the Export Controls Plan, its implementation and oversight
- Review and approve departmental compliance plans
- Oversee training on Export Control issues and policies
- Conduct annual refresher training
- Ensure recordkeeping
- Ensure audit findings are addressed in a timely manner
- Monitor access by foreign nationals to covered technology and data
- Examine contracts for restrictions on personnel who may be used on the project or restrictions on those who may have access to the technology or data

In addition to absorbing the oversight function into the structure of the organization, four specific screening points should be monitored

- Legal Counsel must verify that no federal laws or regulations are violated in relationship to financial support for foreign collaboration, foreign entities providing goods and services to the company, or the company providing goods and services to a foreign entity which is on any list of embargoed countries
- The Office of Human Resources must screen and clear foreign nationals who are finalists for employment to ensure potential employees are not included on government lists, and alert other divisions regarding potential restricted access for certain foreign nationals employed.
- The Safety Officer must inventory and record all hazardous chemical and radiological material, since, at a minimum, export control regulations dictate that hazardous materials, which might be used for terrorist activity, must be safeguarded.
- Purchasing, Receiving and Shipping must screen all vendors and equipment suppliers to ensure that they are not on any government lists. It is also imperative that the actual shipment of equipment and samples be coordinated with Legal Counsel and the EO to determine whether or not an export license is required

BIS, which administers the licensing program for the Commerce Department, provides support for companies to implement compliance systems in order to establish a process for the evaluation of the requirements and the documentation of compliance with those requirements based upon the type of product being exported, the country to which the product is being exported, the entity or person to whom the product is being exported, and the applicable requirements in such circumstances (Meagher, 2002).

DDTC in the State Department also provides guidelines for a compliance program (Guidelines for DTC Registered Exporters/Manufacturers Compliance Program, 2006). DDTC suggests that companies develop operational compliance programs, which include manuals that articulate the processes to be followed in implementing the company program. It advises that manuals and programs include

- a detailed organizational structure which describes the company's trade functions and control structures for tracking compliance
- a directive by senior management indicating corporate commitment to ensure compliance

- methods tailored to the corporate structure, organization and functions which are designed to identify, tag, and account for export controlled items, data, and transactions
- procedures for the re-export and re-transfer of items or technical data
- procedures for screening customers, carriers and countries for restricted or prohibited exports and transfers
- the implementation of a recordkeeping system for U.S. origin products
- the establishment of and internal audit system for periodic compliance checks
- a company training program on export control regulations
- procedures for the notification of potential violations and employee discipline
- the establishment of an Ombudsman office to investigate problems and provide independent evaluations on the effectiveness of the compliance program

Drawing from these resources, Rege (2006) provides suggestions for the implementation of an internal control program for universities to insure compliance, which readily translates to business operations as well:

- develop a policy statement clearly indicating their commitment to complying with export control law
- fortify the policy with education programs and training manuals for key personnel
- identify a department with primary responsibility for ensuring compliance and implementing a comprehensive accounting system, which maintains records of completed transactions for at least five years, as generally required by BIS and DDTC
- conduct periodic internal reviews to verify compliance, including unannounced visits to relevant areas of the operations
- implement a well-publicized system of notification procedures to follow for questions that may arise regarding the propriety of specific transactions, which includes corporate counsel in the information loop
- develop procedures to continuously monitor OFAC's list of Specially Designated Nationals, as well as BIS's "Denied Person List," which registers individuals and entities that have been denied export privileges and with whom business may not be transacted

Measures such as these, if implemented, serve not only to manage potential risks, but also to create a corporate culture of compliance. As companies are under an obligation to self-regulate, corporate leadership must create such a culture of compliance and ensure that violations do not

occur, particularly since enforcement provisions consider compliance as an aggravating or mitigating factor once culpability is determined (Morris, 2006).

CONCLUSION

Entrepreneurs who export items with military or dual use capabilities or employ foreign nationals must be familiar with the ITAR and the EAR. These export control regulations are designed to ensure that businesses comply with regulations that restrict the export of goods, technology and related technical information to countries that have been identified as a threat to our homeland security or economic status. The control of arms sales to foreign parties is an integral part of the U.S. ability to safeguard national security and further foreign policy objectives in an environment of burgeoning conventional arms and technology transfers (Dhooge, 1999). The response to terrorism and a concern for the export of sensitive technology, particularly to China, likely will continue to shape export control policy in the near future (Chapman, et al, 2006).

Table: Summary of Export Controls

Federal Department	Enabling Legislation	Regulation Sanction, Embargo	Administering Body	Applies to
Department of State	**The Arms Export Control Act (AECA)**	International Traffic in Arms Regulations (ITAR)	Directorate of Defense Trade Controls (DDTC) • Office of Defense Trade Controls (ODTC)	Manufacture, import, export, transfer, brokering of defense related trade & technology transfers: blueprints, drawings, plans, instructions, diagrams, photographs
		• United States Munitions List (USML) • Visual Compliance (software)	(Companies producing, furnishing, or exporting items requiring a license must register with the ODTC. See "D-Trade")	21 Categories: *Capability* of use for military purposes: equipment, software, military electronics, chemical & biological agents inherently military in character).

Table: Summary of Export Controls				
Federal Department	Enabling Legislation	Regulation Sanction, Embargo	Administering Body	Applies to
Department of Commerce	**Export Administration Regulations (EAR)**	• Denied Persons List • Unverified List	• Bureau of Industry and Security (BIS)	Dual Use items – good and technology primarily commercial (not military in nature) which may have dual (military) use
		• Commerce Control List (CCL) (10 product & technology categories)	• Office of Export Enforcement (OEE) • Office of Anti-boycott Compliance (OAC)	License requirements dependent upon an item's technical characteristics, the destination, the end-user, and the end-use.
Department of Treasury		• Specially Designated Nationals List (SDN)	• Office of Foreign Assets Control (OFAC)	Enforces economic sanctions and trade embargoes prohibiting transactions with countries, entities and individuals subject to boycotts and trade sanctions

This paper has provided an overview of the regulatory maze with suggestions for compliance programs to insure that businesses steer a proper course through this complicated system of controls. To reiterate, licenses may be required by the Departments of Commerce or State if information, technology, items or services are controlled under the respective regulations. Controlled items, information or software designed or modified for a military use, or capable of dual use (civilian and military), may be covered by the regulations. In addition to the actual transfer of items and technology, the regulations also prohibit the disclosure of controlled technical information by any method to a foreign national in the U.S. or abroad without a license from Commerce or State. Therefore, care also must be exercised with respect to foreign national employees, both here and abroad. The following table summarizes the most basic information from the article above:

WHERE TO GO FOR HELP

The small business seeking additional or up-to-date information for complying with the laws and regulations discussed in the article above may find the following web links useful:

- Society for International Affairs, Inc. *Educating the International Trade Community on Import and Export Processes* (2008): http://www.siaed.org/
- *The Fed Ex Export Logistics Guide*: http://exportlogisticsguide.com/fedex-and-us-commercial-service-agreement-to-boost-us-small-medium-business-exports

- U.S. Department of Commerce:
  - *A Basic Guide to Exporting*, *Preparing Your Product for Export.* U.S. Department of Commerce (with the assistance of Unz & Co., Inc): http://www.unzco.com/basicguide/c7.html
  - *The denied persons list* from the Bureau of Industry and Security (note additional links in the left margin): http://www.bis.doc.gov/dpl/thedeniallist.asp
  - *Introduction to Commerce Department Export Controls* (2007): http://www.bis.doc.gov/licensing/exportingbasics.htm
  - *Department of Commerce, Lists to check*: http://www.bis.doc.gov/complianceandenforcement/liststocheck.htm

- U.S. Department of State
  - *Compliance program guidelines*, Directorate of Defense Trade Controls (2008): http://www.pmddtc.state.gov/compliance.htm
  - *Getting started with D-Trade*, Directorate of Defense Trade Controls, (2008): http://www.pmddtc.state.gov/getting_started_with_dtrade.htm
  - *Preparing a complete registration package,* Directorate of Defense Trade Controls, (2008):http://www.pmddtc.state.gov/registration.htm

- U. S. Department of Treasury
  - Office of Foreign Assets Control (2007) http://www.treas.gov/offices/enforcement/ofac

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THE ACCESS TO CAPITAL FOR ENTREPRENEURS ACT OF 2007: AN EXTENSION OF THE IMPACT OF TAX POLICY ON INFORMAL VENTURE INVESTING

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> "(D)oes a tax credit 'really lead to investments? Does it make an investor invest in bad deals? Does it make people who should not be investing invest?"'
>
> (Preston quoted by DeBaise 2007: R6).

Government policy makers often look towards the small and medium sized business (SMEs) sector for job creation and other economic development benefits such as increasing the tax base. U.S. Congressman Don Manaullo's January 19 press release on creating anew federal tax incentive for early stage business angel investment notes that four jobs are created for each angel investment, resulting in net job creation and economic development benefits. Even without federal tax incentives to encourage additional angel investing the informal venture investment market grew by 10% during 2006 (Wright 2007).

The U.S. Small Business Administration has championed the cause of SMEs through management development and training programs such as the Small Business Development Centers, Service Core of Retired Executives (SCORE), including management training opportunities available on-line through SBA's web portal. However, while both management and marketing capabilities and opportunities define an entrepreneurial venture's success, the limiting factor for many entrepreneurial ventures is simply the lack of early stage seed and risk capital. Wise and Miles (2003: 11) suggest that:

> "Policy makers in the U.S. and Europe understand that entrepreneurship by large and small corporations can be influenced both by regulatory controls and reward structures…Government policy makers, globally, tend to rely on two major categories of tolls to induce entrepreneurial activities by corporations (or SMEs): (1) tax incentives; and (2) direct government support."

The Access to Capital for Entrepreneurs (ACE) Act of 2007 is designed by government policy makers as a private sector solution to increase the supply of early stage seed capital for high potential entrepreneurial venture by creating a tax incentive for "qualified investors" to take equity

positions in SMEs. The ACE act of 2007 follows the example of several states which have allowed individual angel investors or angel investment pools to benefit from a 25% tax credit, up to a maximum credit of $250,000 for informal venture investment held for at least three years. This investment tax credit has created an economic incentive to encourage additional angel investing.

HOW DOES THE PROPOSED TAX CREDIT FUNCTION?

Individuals and investment partnerships made up of only "qualified investors" are entitled to claim an investment tax credit when making informal venture investments in a "qualified small business." SMEs are qualified by size standards, domicile in the U.S., and corporate control (see HR 5198).

A recent paper by White, White, and Miles (2006) suggests that the topic of angel investing has recently become much more important to small businesses and government policy makers and explores the question: "Is informal venture investing an economically rational decision?" This study updates that discussion in light of the proposed Access to Capital for Entrepreneurs (ACE) Act of 2007. Specifically, this study incorporates the implications of the proposed federal investment tax credit for informal business angel investments on potential rates of return. In this case, the internal rate of return on informal venture investments is evaluated in a scenario where the business angel can benefit from the financial effect of ACE.

The proposed legislation for Angel Investments proposes to allow a qualified investor a 25% tax credit for an equity investment in a qualified small business. This means that a qualified investor who makes a $1,000,000 investment in a qualified small business will receive a $250,000 tax credit. This tax credit lowers the investor's federal tax liability by $250,000. This means that an investor who owes $300,000 in federal income taxes will have his tax liability reduced to $50,000 [$300,000 - $250,000]

The investor's tax basis (investment) in the equity investment is reduced dollar per dollar by the amount of the tax credit. This means that the investor in the above example will have an adjusted basis of $750,000 [$1,000,000 - $250,000]. If the investor sells the equity investment at a gain, the gain will be measured as the difference of the Amount Realized (gross sales price less cost of the sale) [1] and the investor's adjusted basis in the investment (cost plus capital additions less capital recoveries) [2] Accordingly, if the investor sells the investment for $2,000,000, the investor will realize a gain of $1,250,000 [$2,000,000 - $750,000].

If the investor is an individual, the investor will be entitled to a capital gains preference depending on how long the investor held the stock and how the investment is classified for tax purposes. If the stock is classified as IRC Section 1202 stock (stock in qualified small businesses) the stock is entitled to a 50% exclusion from tax if the stock is held for more than five year. The regular tax rate for Section 1202 stock is 28%. Therefore the effective rate is 14% after the 50% exclusion.

If the stock is not classified as Section 1202 stock, the individual investor is allowed a tax preference that will tax the gain at a maximum rate of 15% providing the stock is held for more than a year. [3] Corporate investors who are taxed under the rules of subchapter C of the Internal Revenue Code receive no tax preference on capital assets regardless of the holding period.

If the investor sells the stock at a loss, the amount of the loss allowed in any given year depends on a number of different circumstances. If the stock qualifies as small business stock under IRC Section 1244 the maximum loss allowed in any year is limited to $50,000 ($100,000 if filing a joint return). Therefore, if the stock in the small business becomes worthless, the investor realizes a $750,000 loss [$0 - $750,000]. If the investor is not married, the investor is allowed a $50,000 loss the first year and the rest of the loss is treated as a long term capital loss. Individual investors are allowed a maximum deduction of $3,000 per year on net capital losses. If the investor was married and reports the loss on a joint return, the investor may deduct $100,000 in the year of the loss and deduct the rest as a long term capital loss. The $100,000 loss is allowed regardless of whether the stock was held by one spouse or by both spouses. Any loss not used in the year of sale is treated as a net operating loss and may be carried back two years and/or forward 20 years. [4]

If the investor is single, the investor will have $700,000 in long term capital losses [$750,000 - $50,000]. If the investor is married, filing a joint return, the amount of the long term capital loss is $650,000 [$750,000 - $100,000]. These losses can be carried forward indefinitely but will die with the taxpayer. Of course the investor may use these long term capital losses to offset current capital gains. The best use of the loss would be to offset current short –term capital gains which receive no preferences and are taxed an ordinary income rates.[5]

If the investment is treated as a passive activity, there are additional complications. If an investor invests in a partnership or in an S corporation, either entity passes gains and losses through to their investors. If the investment makes money, the income flows through to the investor who is currently taxed on the income regardless of whether or not the income is distributed to the investor. If the investment looses money, the losses pass through to the investor. However, if the investor is a limited partner or does not materially participate in the investment, the investment is treated as a passive activity. [6]

Losses from a passive activity are suspended unless the investor has income form a passive activity to offset the losses. Even if there is income from a passive activity, the loss will be disallowed if (1) the loss exceeds the investor's basis or (2) if the investor is not at risk with respect to the basis.

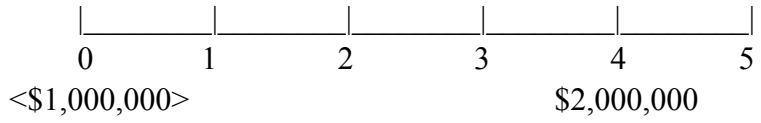
If the investor invested in a passive activity, our investor will not be able to deduct losses passing through to him if the losses exceed his basis (currently $750,000). If the investor borrowed money to purchase the investment and the loan is characterized as a non-recourse loan (the lender has no recourse beyond the collateral) the investor will not be able to deduct losses beyond the investor's economic risk.[7] For example of our investor borrowed $700,000 as a non-recourse loan with the stock as the only collateral, our investor is only at risk to the extent of $300,000 [original

investment of $1,000,000 less $700,000) Since $250,000 of the basis was reduced by the credit, our investor is only at risk to the extent of $50,000.

If there is no passive activity income to use as an offset, the losses are suspended indefinitely until the investor sells his entire investment in the passive activity in a taxable transaction.

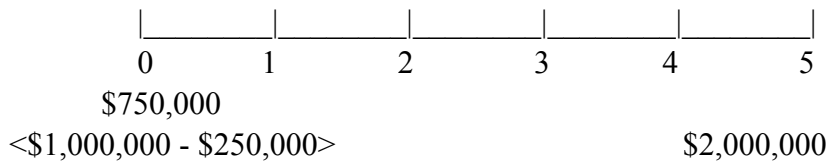
RATES OF RETURN UNDER ACE 2007

Consider a project that requires an angel investor to commit $1 million dollars with a 10% probability of a maximum upside return of $20 million in five years. The expected value of the investment is $2 million. In the absence of any special tax treatment of angel investments, the investment has an expected return of 14.8%. This investment is shown on the timeline below.



IRR = 14.8%

However, that same project's return would increase to 21.7% if the project qualified for the ACE 25% investment tax credit. This investment is shown on the timeline below.



IRR = 21.7%

This rate of return is nearly 46% higher than the same investment without the proposed federal ACE investment tax credit. It is not unreasonable to assume that investors will respond to such a dramatic increase in returns. Projects that were marginal without the ACE investment tax credit become very attractive if the returns rise by over 40%. It should be noted that this increase in returns is not the result of an increase in the project's risk. In fact, while the risk of the later cash flows is unchanged, the cash flow resulting from the tax credit is immediate and risk free. Therefore, the project's overall cash flow risk has decreased.

CONCLUSION

It is clear that the ACE proposal will make angel investing significantly more economically attractive. Increased angel investing will provide more seed and start-up funds for promising entrepreneurial ventures resulting in an increase in economic activity and job creation. In addition, our analysis suggestes that the ACE investment tax credit will not create disincentives for investor due diligence as the tax credit is limited to 25% of the first $1,000,000 invested. Angel investors by regulation and definition are sophisticated investors who have the resources and capabilities to properly vet investment opportunities, and the desire to achieve high portfolio rates of returns. The ACE federal investment tax credit proposal will simply reduce the downside risk for angel investors in an effort to stimulate additional investment into high potential entrepreneurial firms. Enactment of the ACE federal investment tax credit will benefit entrepreneurs, angel investors, and the nation's economy.

ENDNOTES

[1] IRC Section 1001(b).

[2] IRC Sections 1011 and 1016.

[3] IRC Section 1(h).

[4] IRC Section 1244(d)(3)

[5] IRC Section 1222.

[6] IRC Section 469.

[7] IRC Section 465.

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ENTREPRENEURIAL INVESTMENT IN THE SHKODRA REGION: OPPORTUNITIES FOR WOMEN IN TOURISM

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ABSTRACT

Despite its desirable Mediterranean-Continental climate, coastal location and agricultural resources, outside investment in the Shkodra region of Albania is needed in order to improve economic development in the region. After 46 years of Communist rule, Albania began its transition from a xenophobic Communist country to an emerging democracy in 1990. This political transition has produced challenges for economic development in Albania. In the midst of this political transition, women in Albania have begun to supersede adverse situations by transforming their roles in society, and therefore breaking out of once limiting paradigms through their entrepreneurial endeavors. Research indicates that service industries, such as tourism, offer a natural transition for such post-soviet economies. Initial investment in education and government programs appear to be facilitating female entrepreneurial involvement in the tourism industry in particular. By concentrating initially on tourism, the Shkodra Region can encourage entrepreneurship in a way that can maintain some consistency with the traditional role of females, while sustaining the region's natural beauty and revealing the skills of its artisans. Suggestions for further facilitation of women's economic involvement are offered.

Search words: [women entrepreneurs; tourism; ecotourism; artisans; post-communism; investment]

INTRODUCTION

Albania is an untapped investment opportunity for the international entrepreneur. With abundant mineral resources, a desirable Mediterranean-Continental climate, and growing political stability, increased investment in the Shkodra region could lead to economic stability and be profitable for both the entrepreneur and Albania (Hall, 2004). Furthermore, investments in this region will help increase female employment and alleviate the strain of adversity that female entrepreneurs in the region face. This paper will address seven main areas of interest, namely: i) geography and climate, ii) political state, iii) infrastructure, v) tourism development initiatives, vi) human resources development for the tourism industry, and vii) family tourism. These sections will

detail the opportunities for investment for the international entrepreneur considering investment in Albania, and in the Shkodra region in particular.

GEOGRAPHY AND CLIMATE DETAILS

Prior to discussion of Albania's investment opportunities, it is essential to place Albania and to inventory its basic climate details. Albania is located in southeastern Europe and has land boundaries with Kosovo, Montenegro, The Former Yoguslav Republic of Macedonia, and Greece, as well sea borders with the Ionian and Adriatic seas. It encompasses 28,748 square km, an area that is slightly smaller than Maryland and has a population of 3,563,112 (Albania Geography, 2005). The Shkodra region in particular has a diverse geographic landscape that includes a coastal area, plains, rivers and a mountainous region. The region's Mediterranean - Continental climate nurtures the region in the winter with rains and warms it with hotter, dryer summers, and an average annual temperature of 59 degrees Fahrenheit (Albania Climate, 2008). Albania's location and its desirable climate will be discussed further when the opportunities for investment in the tourism industry are discussed. Before discussing the investment opportunities, it is essential to determine Albania's location in the political and economic landscape. This will help provide a more in-depth understanding of the country, beyond its surface characteristics.

ALBANIA: AN EMERGING DEMOCRACY

Since its emergence from 46 years of Communist rule in the early '90s, Albania has struggled to reach the economical success of other post-communist countries such as Hungary. In Hungary, the strengthening of domestic tourism has proven to be a positive influence outside entrepreneurial investment (Hall, 2004). Albania, however, has faced several challenges during its political transition that must first be addressed before investment in tourism is further explored.

One of the biggest challenges for Albania is a philosophical transition from the communist mind set to that of the market economy. Certain expectations must change. For example, some basic "rights" (i.e., right to be fed, educated and healthy) of the communist's regime have transitioned into basic "needs" in the post-communist economy. Women in their central role within the family have particularly felt this transition and are endeavoring to find solutions by capitalizing on new roles and opportunities (Ghodsee, 2003).

Another challenge was the reemergence of socialist views within the political arena. Albania as a whole, struggled during its political transition due to the pyramid investment scandal in 1997, which led to the election of the Socialist Party and the loss of power for the Democratic Party of Albania (DPA) (GTZ, 2008). This change in power provoked the Organization for Security and Cooperation (OSC) in Europe to become involved. The efforts of the OSC helped reestablish democracy in Albania and the DPA currently controls all of the country's main public offices until the next parliamentary election in mid-2009 (Albania Economy, 2008).

Corruption is a common by-product in a transitioning economy, but some are more successful in battling this. For example, the Ukraine continues to struggle, while Hungary has made a relatively successful transition to a market economy (Wells, Pfantz & Bryne, 2003). One key difference is the creation of private entrepreneurial ventures. The Shkodra Region is endeavoring to embrace such change but investment is needed.

Finally, infrastructure provides its own challenges in its support of the economy. While statistics such as a projected GDP growth of 6% in 2008-09 indicate positive changes in the Albanian economy, contrasting statistics such as an unemployment rate of 15 percent and ten percent of the population living on two dollars or less per day emphasize the need for further economic development (Albania Economy, 2008). Current power outages also pose a problem for the strength of Albania's economy and highlight one sector of the Albanian infrastructure that is in need of outside investment. A solid infrastructure and positive economic development play a crucial role in Albania's ability to attract international entrepreneurs. For example, Romania, Slovenia, Poland, Croatia and the Czech Republic, are respectively ranked in order of their potential for entrepreneurial activity. Interestingly, findings suggest the differences in entrepreneurial potential are best explained by the level of economic development as opposed to the country specific factors such as culture and experience with a market economy (Mueller & Goiæ, 2002). Given this information, it is obvious that basic infrastructure improvements and the support of government are paramount to create such opportunities in Albania. A further discussion of the Albanian infrastructure will address other areas that are in need of development in order to lay a proper foundation for the advancement of the tourism industry.

INFRASTRUCTURE: THE NEED FOR INVESTMENT AND IMPROVEMENT

The potential effects of further development of Albania's infrastructure are far reaching and relate very closely to the overall goal of benefiting the Albanian economy with investment and growth in the tourism industry. The success of investment in the tourism industry depends to a great extent on the infrastructure in the region. The following section provides an overview of the current state and the needs of the telecommunication and transportation segments of the infrastructure in Albania and the Shkodra region in particular.

Despite development in the last ten years, the telecommunication segment of Albania's infrastructure still requires development in order to accommodate modern needs. The Italian Telecom established a new building in January 1999, and laid new underground telephone lines providing a service that helped increase domestic telephone service for the Shkodra region. In 2001, there were a reported 120,000 main line telephones and 250,000 cell phones in Albania (Albania Fact Book, 2001). Albania as a whole, however, is still has one of the poorest telephone services in Europe with fewer than two telephones per 100 inhabitants (Albania Fact Book, 2001). This lack of funding in the telecommunication segment has effects that extend beyond internal communication issues. Albania's neighbors, Italy and Greece experience microwave radio delay from the Tirana

exchange point (Albania Fact Book, 2001). In order to compete in the global economy and draw from the global tourism base, the telecommunication segment must be modernized.

In addition to telecommunication, transportation is another area of the Albanian infrastructure that must be improved in order to support the desired growth in the tourism industry. The state of the transportation sector can serve as either a promoter or an inhibitor for tourist interaction in the region in terms of cultural contact and mobility (Hall, 1999). The following sections provide information regarding Albania's current transportation capacities.

In Albania, highways reach 18,000 km and of this distance, only 5,400 km are paved. The roadways in the Shkodra region reach a distance of 558 km, of which 136 km are national roads, 295 km are paved and the remaining 117 km are not paved. The status of the roadways must be improved because development of the economy is dependent upon the development of both the telecommunication and road transport segments.

The Albanian national railway network is also in need of improvements. The railway network in south-eastern Europe is not of the same caliber as the network in central Europe. Development in the railway network is necessary to improve existing railways in addition to creating new railways. The construction of new railway branches will facilitate work and eliminate train delays.

Lastly, investment in lake transport could connect the city of Shkodra with Montenegro and the whole of Europe. Further more, reactivation of this form of transportation could stimulate the development of tourism by increasing domestic and foreign exposure to Shkodra's lakes and coastlines. Thus, the investment in and development of the Albanian infrastructure, will lead to better conditions for the country's industries and agriculture.

INDUSTRY AND AGRICULTURE

The following is a brief account of the Shkodra region's industry and agriculture opportunities, excluding the tourism industry. Investments in agriculture and industries other than the tourism sector will have effects similar to those produced by investment in the infrastructure. While the tourism industry is of particular interest in this article, investments in the accompanying industries and the agriculture are essential to the tourism industry's success.

With its rich mineral reserves, extensive hydro options, and abundant forest there is a great opportunity for further development in mining, energy and forestry. Corresponding new investment could also breathe life back into wood (e.g., woodworking), building, food, artisan (e.g., jewellery, textiles and clothing) and agriculture industries - all of which are in serious need of capital. Increased activity in these industries will provide not only an increased variety of goods for tourists, but also an increase in exports. This article aims to serve as a tool for further serious inquiry into the entrepreneurial opportunities present in the Shkodra region. The next sections provide brief overviews of each industry.

Wood Industry

There are twelve enterprises in Shkodra dealing with wood sawing and woodwork: two enterprises of sawn timber, six enterprises of furniture production, and four of different wood fibre-plate production. All of these enterprises have new premises; however, the old technology limits and interrupts production. Thus, there exists a great opportunity for outside investment in new technology for these enterprises in order to bring them into the twenty first century and allow them to satisfy an ever-growing market demand.

Building Industry

Before 1997, seventy building enterprises operated in the Shkodra district, but this number has dropped considerably since then. The building material industry consists of ten small enterprises, operating with a primitive technology resulting in fairly low production. The building products needed in Shkodra's only brick factory (e.g., cement, bricks, roof-tiles) are provided by other zones despite Shkodra's wealth in the raw materials needed for their production.

Food Industry

The food industry of Shkodra consists of seventy-four bakeries, two refreshments (drinks) and mineral water factories, six alcoholic drink factories, two confectionaries, one tobacco factory, two macaroni factories, two meat products factories, one sauce factory and two soap and other detergents factories. The technology in the food industry is obsolete, except for the bakeries and once again, foreign investment is needed in order to increase exports in this industry.

Light Industry and Artisanship

Light and artisan industry products have an old tradition in Shkodra. The artistic products of silver and filigree, and many jewelries of copper and different stamps on platforms of cooper, the artistic wood objects, the metal and hay application on wood, the very beautiful and colorful "sixhade" (a kind of small carpet), the different "zunkth" products (a kind of hay), fabric and knitwear, have always competed with dignity in the international market.

Tourism Industry

Given Shkodra's geographical position, it is obvious that in addition to investments in the infrastructure and the aforementioned industries, an investment in the tourism industry could be especially profitable. The tourism industry consists of four sectors of investment possibilities in the Shkodra region including urban tourism, mountainous tourism, coastal tourism, and lake tourism.

The development of urban tourism in the city of Shkodra can be combined with the other sectors of tourism. For example, tourists visiting the city to see its traditions and monuments will also have the ability to visit Velipoja Beach, the picturesque village of Shiroka or the mountainous zone of Razma. This diversity will be elemental in the first phase of tourism development, the process of marketing the region as a full package vacation destination.

Despite its current economic shortcomings, Shkodra possesses sufficient human resources to offer the tourist market a quality product acceptable for international tourist standards. However, some specific sectors such as the major hotels in Shkodra city are in need of improvement. In addition, the youth of Shkodra have an educational and cultural level sufficient enough to be integrated at once into a developed tourism industry.

Another positive indicator of the potential for investment in the tourism industry is the large percentage of the upcoming workforce that speaks various foreign languages, especially Italian. In addition to its multilingual capacities, the work force also has a rich tradition in the fields of agricultural, artisanship and artistic products of national character that enrich and render the tourist offering more attractive.

TOURISM DEVELOPMENT INITIATIVES

Outside interest in assisting tourism development has already begun. German Technical Cooperation (GTZ) is a worldwide service enterprise focused on development. GTZ actively supports countries in transition and serves as a catalyst to the introduction of comprehensive reform processes, and helps to initiate the necessary changes in policy, economic and social framework these require. In this context partnerships between the public and private sectors play an increasingly important role. GTZ has initiated several projects in Shkodra tourism field. The most important ones are:

Lake Shkodra Region

Regulated and planned urban development of the Lake Shkodra region will provide the basis for economic development of tourism sector and ecologically sustainable tourism development. The activities of this project are regularly coordinated with programs of other international and bilateral donors, (e.g. the Austrian Development Agency (ADA), Regional Environmental Center (REC), Netherlands Development Organization (SNV), USAID, United Nations, the World Bank). The project will follow a two – level approach.

At the cross-border level, provide a development and management concept for the lake area as a non-administrative regional unit. This concept will show appropriate approaches for integrated development in consideration of spatial opportunities and limitations within the target area. It will implement harmonized bilateral measures in the field of local planning and initiation of small scale investments in infrastructure for further development of tourism. These interventions should

increase awareness on the respective sides of the Lake area and contribute to the forming of social capital.

Velpoje Beach

This is a project related to tourism development in Velipoje Beach, named "Velipoja villages have a future in tourism". The project aims to create a better tourism concept for these villages, to increase awareness of the local community regarding the ways for tourism development efforts for improving the local infrastructure and preserving the local resources. Grass root projects that engage students in collaboration with the Leaders of the Villages have identified the potential for environment improvement/preservations and tourism development

My Village

GTZ started with the sub-project "My village has a future in tourism" aimed to:

- Identify tourist potentials in the North
- Involve the local community in Tourism Development Initiatives
- Identify actual problems and suggest solutions
- Set up a long term tourism product

This project started in March 2005 and finished in an open competition in June 2005. Different partners were involved, Economic Faculty and History and Geography department from Shkodra University „Luigj Gurakuqi", Shkodra District Local Governments, including those communities and municipalities offering a tourism. Student teams assessed different tours including a specified description of attractions and their viability. These teams (12, two member teams) discussed the future of tourism for the different locations of Shkodra region and all over Northern Albania. The next step represents the making of tourism map including all the resorts in North Albania. During the last summer period, GTZ engaged economics students to interview tourism entities involved in the Velipoja resort (each one addressed 250 questionnaires to tourists and all hotelier structures). The objectives were to:

- Collect information on Hotels, represent it in one brochure
- Create a written analysis of typology of visitors across two consecutive years
- During the summer time this project included the support offered to Mrs. Renate N. Ndarurinze, a writer and journalist working on a tourist guide of Albania.

Theth

A project related to Tourism development in Theth (north of Shkodra city) aiming at reconstruction of typical Albanian buildings named "kulla" in order for them to be ready to accommodate international tourists. The project will support architectural work, provision for sanitary equipment, provision of furniture for kitchen and other rooms that will be at disposal of tourists, training of tourism employees and guides. The sum financed by the project for each family will be approximately 2000 EURO.

These GTZ projects represent the beginning of the process of tourism development in Albania. In addition to these projects, steps have also been taken by the German Rector's Conference to increase human resource development in the Shkodra city. This development will be presented in a short discussion followed by a table that will highlight the strengths, weaknesses, opportunities and threats for investment in the tourism industry in the Shkodra city.

SWOT ANALYSIS FOR SHKODRA CITY

German Rectors's Conference (HRK) is an academic institution which has contributed greatly in the consolidation of the Tourism branch at Shkodra University. This branch has been opened at Economic Faculty of Shkodra University since September 2003 according to the Bologna agreement on system 3+2. German Rectors Conference has financially supported two projects of Eberswalde University in collaboration with Shkodra University at which students have been engaged in very practical work, resulting in the publication of a Shkodra Cycling Tourism map around Shkodra Lake (finished in December 2005) and a Cycling Tourism map around the Shkodra mountain region to be finished in December 2006. Also, GRK is supporting the opening of a Master in Sustainable Tourism (by September 2008) at Shkodra University in collaboration with Tourism Faculties of three partner universities: Montenegro University, Eberswalde University and Munich University

Table 1: S.W.O.T. Analysis for Investment in Shkodra City Tourism

Strengths	-A favorable geographic position being as cross border city with Montenegro (Podgorica 56 km) -Positioned by the greatest lake in Balkan that has the name of the city "Shkodra Lake" -A lot of cultural attractions (e.g., Rozafa Castle, characteristic houses, museums, cultural traditions). -Three kinds of tourism available: beach tourism, lake tourism, mountains tourism, cultural-city tourism -Having a rich tradition in economic development: Over 200 years as a prime merchant's city, positioned along the ancient trade route between the Mediterranean Sea and Kosovo in the interior. -Strong trade position with different European Countries being an inland port, with 250 shops in the famous Shkodra bazaar and 80 types of crafts represented. -Before 1990's Shkodra was one of the main Albanian industrial and economic centers.

Table 1: S.W.O.T. Analysis for Investment in Shkodra City Tourism	
	-Labor skills were highly specialized related to processing of the regional raw materials and traditional skills. -Now Shkodra has a about 1700 businesses of which 25 are joint capital companies, 14 are foreign capital and the remainder are Albanian capital (Shkodra Municipality – Economic Development Department, 2006). -Offers the best agricultural productivity and stockbreeding products in all over Albania. -Possibilities in combining of tourism development with other economic branches such as agriculture, processing industry, electric hydropower station industry. -Shkodra has a continuous demographic growth and a young work force population: Population: Municipality = 110 000; Region = 243 000; Average age = 27; aging coefficient = 8%; Work force/ population = 29% -The Shkodra municipal economic development department, the Shkodra chamber of commerce, and Shkodra University "Luigj Gurakuqi" (with a tourism branch at Economic Faculty) are a strong support for any new venture in the city. -There are 11 banks operating in the city and 4 business credit institutions (e.g., Raiffeisen Bank, Procredit Bank, Tirana Bank, Italian-Albanian Bank). -There is an economic development strategy of Shkodra Municipality which is supported by Co-Plan and World Bank.
Weaknesses	-Infrastructure in process (e.g., road development). -Need more qualified tourism employees. -No predetermined budget from Shkodra Municipality for promotion and territorial marketing in Shkodra region. -Shkodra region is missing the quality controls according to standards of superstructure system related to tourism service providers such hotels, tourist agencies, bar-restaurants, transport businesses etc. -Relatively high level of bureaucracy and corruption at public administration that deals with licenses of new opened businesses although the fight against corruption has been claimed a priority of government and improvements are appearing
Opportunities	-Tourism development has been claimed as a priority of actual Albanian Government program. -Favorable business climate where actual Albanian government has supported small businesses with lowering taxes.
Threats	-Competition from Montenegro Tourism Industry. -Lack of foreign direct investment especially in tourism field.

A FOCUS ON SHKODRA CITY HOTELS

In addition to the SWOT analysis of the tourism industry in the Shkodra city, a SWOT analysis of three major hotels in the Shkodra city will provide a detailed perspective of a particular aspect of the tourism industry in the city. Despite our focus on ecotourism and its potential to positively impact female employment, an analysis of the comforts afforded by the mass tourism model (such as hotels) is important for tourism in general and for taking some of the strain off of the rural

initiatives (Weaver, 2001). Table II will outline the SWOT analysis and recommendations will follow.

Table 2: S.W.O.T. Analysis for Three Major Hotels in Shkodra City

	Colosseo Hotel	Marku Hotel	Rozafa Hotel
Strengths	-location (potential access to main roads) -quality of staff, service and menu -cooperation with tourist agencies -competitive prices -yearly activity (occupancy rate is 90% during 2004-2005)	-location nearby Shkodra lake -a diversified offer; using its restaurant spaces for big parties (wedding parties, youth parties) -actual investment in expanding to a new building -nice garden and a good menu	-location (potential access to main roads) -lots of space for family parties -competitive prices -parking space -income from the rent
Weaknesses	-parking space -small number of rooms -small space for bathrooms -too little information on the internet -absence of a telephone-exchange	-poor promotion -the absence of a proper salon for conferences -no web page -missing of qualified staff -missing of an appropriate parking place	-lacking professional administration -the absence of promotion -staff requires service and professionalism quality training -occupancy rate is 40%
Opportunities	-location in the centre of city -equip hotel rooms with computers -draw attention towards it as a chain of hotels -promote as a connection point with Montenegro	-increasing the number of rooms -new upcoming investments in hotel buildings -enlarge of common areas -sales through Internet	-location in the centre of city -hotel requires reconstruction -rent parts of the hotel -refurbishing (replacing the furniture)
Threats	-competition -electrical energy -international and regional infrastructure	-competition -electrical energy	-competition from 14 hotels operating in Shkodra city -power supply -no funds

Source: onsite interviews, observations and hotel classification guide

Colosseo Hotel

The Colosseo Hotel enjoys a central location with access to main roads as well as a 90 percent occupancy rate in 2004-2005. While Colosseo Hotel has a higher occupancy rate than the other two major hotels included in our study, there is still room for improvement. Due to its already high occupancy rate, the number of rooms and parking spaces needs to be increased in order to meet the desired increase in tourists to the city. In addition to this, the size of the bathrooms needs to be enlarged and both telephone and internet availability needs to be addressed in order to properly market the hotel to potential tourists.

As is true with the Marku Hotel and the Rozafa Hotel, Colosseo faces competition from the other 14 hotels operating Shkodra city as well as challenges posed by a poor infrastructure. Despite these challenges, there is opportunity to increase revenue at the hotel through a variety of means such as adding computers to hotel rooms to try and catch up to hotel standards experienced in other areas of the world. The hotel can also be promoted as a connection point with Montenegro.

Recommendations

- Marketing research is needed to better understand consumer behavior; especially those of international tourists
- Enlarge parking area and increase the number of rooms
- Install phone in every room
- Ensure internet access for clients at any time
- Organize training courses for the staff periodically according to European standards in quality management and service.
- Install an alarm system
- Revise the menu periodically with the needs of international tourists in mind
- Provide access to a safe
- Provide facilities for making teas and coffees in rooms according to clients demands

Marku Hotel

The Marku Hotel is positioned nearby the Shkodra Lake and has a slightly lower occupancy rate than Colosseo with 60-70 percent of its rooms occupied throughout the year, however, it possesses many of the same strengths, including a good location and cooperation with both foreign and native tourist agencies. In addition to the weaknesses Colosseo currently possesses, Marku is in need of a proper meeting area for conferences. Competition and a poor infrastructure also pose threats to Marku, but room for improvement also exists. Investment in Marku could help increase the number of rooms and diversify the offer through a proper conference room, as well as increasing sales through internet promotion.

Recommendations

- Create a marketing department
- Increase the number of rooms
- Ensure internet access at any time
- Create a website, to make bookings (reservations) through the internet
- Organize periodic training courses for the staff
- Periodically revise the menu
- Propose price discount for main course outside the usual meal times
- Purchase fire extinguishers
- Add surveillance cameras
- Provide the facilities to make tea and coffee in rooms
- Provide facilities for shoe cleaning
- Provide a fax service
- Provide pens, paper, and envelopes for writing
- Provide a list of prices
- Provide first aid kit

Rozafa Hotel

In 1995, Hotel Rozafa was privatized and given to new stockholders (42 ex-political dissidents under Hoxha's regime). Unlike both Colosseo and Marku, the Rozafa Hotel (being the oldest one - since 1972) has plenty of parking space for guests. It also enjoys a good location with access to many of the main roads and offers potential guests competitive rates. Rozafa lacks professional administration and like Colosseo and Marku, its promotional activity is in need of improvement, however it stands alone with its unimpressive occupancy rate of 40 percent. Rozafa is in need of reconstruction and refurbishing, despite low investment funds. Some funds are being generated by leasing out space (i.e., a 5 year lease with Raiffaisen Bank; and, a 3 year lease with P.SH.M (microfinance institution)); however more local and foreign investment is needed to make the changes required.

Recommendations

- Complete reconstruction of the hotel
- Furnish rooms with necessary furniture, such as: working table, telephone (at least calls with the reception), standard heating, and rubbish bins
- Provide air conditioners, telephone service and lift service
- Engage in marketing research, periodically change menu and provide a price list for rooms

- Provide periodic training of hotel staff and ensure higher standards of cleanliness
- Add fire extinguishers, emergency ladders (steps) and alarm system
- Provide access to a safe

These SWOT analyses of tourism potential in the Shkodra city and more specifically, in three major hotels in the city, provides a foundation for the more detailed issues that will be addressed as we shift in focus from general opportunities in Shkodra city, to more specific opportunities that address our main purpose, creating more employment opportunities for women in the Shkodra region.

TOURISM AS A BENEFICIARY TO FEMALE EMPLOYMENT

The involvement of women has shifted from agriculture to tourism in countries that once stood behind the iron curtain. Tourism has been shown to be a good transitioning strategy that has empowered women, giving them heightened self-esteem and status, shifted workloads, increased awareness of family health and education, strengthened women's groups and given greater input in policies and decision making (Apostolopoulos, Sönmez, & Timothy, 2001). This effect has been particularly noticeable in Bulgaria where the tourism industry has served as a conduit to higher education, foreign language skills, and experience working with Westerners (Ghodsee, 2005). In fact, women working in Bulgaria's sea and ski resorts have been able to use these opportunities to their advantage, successfully navigating the inherent economic challenges (Ghodsee, 2005). The success of Bulgarian women in the tourism industry provides hope for women in Albania who have been unable to find work during the political transition in the last decade.

Despite this success in Bulgaria, incorporating a gender focus in economic growth projects has met with some resistance and reflects a paradigm called WID (Women in Development) (Ghodsee, 2003). The role of women in post-communist countries is still in a state of flux as they incorporate their role of mother to their families with their apparent role as "mother" of tourism and therefore of the local economy (Totelecan, 2004). This transition has the potential to be profitable for women in Shkodra through a variety of tourism mediums.

In Shkodra, there are 341 women that produce artisanship and traditional handmade products. Tourism development could bring the right customers to these traditional products. Also, agro-tourism could be an alternative for female employment as women have the ability to prepare traditional dishes that could be marketed as a regional specialty to prospective tourists. Furthermore, Albanian hospitality has been proverbial for centuries and women have traditionally played the key role in this tradition.

This improvement of female employment via investment in the tourism industry has great potential, but certain problematic issues must be addressed. One of the problems is the training and qualification of the work force in tourism service sector. The villages of the mountainous areas in Shkodra, although economically underdeveloped, have sufficient human resources for the tourist

market, however more training and education for women in tourism is needed as it has been shown to be a crucial ingredient for successful entrepreneurial activities of women in situations of adversity (Swinney, Runyan & Huddleston, 2006; Ayadurai & Sohail, 2006).

Women, in particular, face the following problems in businesses related to the tourism industry:

- Lack of contracts that provide the continuity of the business
- Access to the markets
- Training of new employees
- Lack of a concentrated work
- Protection of products from speculations
- Lack of direct contacts with foreign markets

In order to overcome these challenges, women must orient themselves toward credit institutions. Once women address these issues, their work production can be cultivated and the sector of agro-tourism as a whole can be developed in the Shkodra region. Agro-tourism is a form of tourism that offers tourists the opportunity to live in rural areas and experience the life of its inhabitants which allows tourists to be active participants in peasants' lives. This form of tourism is very engaging for tourists and fits wonderfully with the villages of Shkodra, where the rural way of life is the norm and home-based businesses have proven to be successful in post-communism countries (Izyumov & Razumnova, 2000).

The mountainous country sides of Vermosh, Razem and Theth have the potential to produce and sell agricultural and animal products and to provide tourists with an in-depth view of the Albanian culture. For example, in a peasant's house from Vermosh, a tourist can find tranquility, pure nature, tradition and rich culture. In turn, this use of hospitality as a form of income will increase the employment and participation of the women of these villages.

In addition to agro-tourism, there is opportunity to increase female employment in the Shkodra region by marketing Vermosh cheese production. This production is characteristic of the Shkodra region and the marketing of this product would not only provide income for those who produce it, but also increase the popularity of the region. Women make the main contribution in the production of this product, so an increase in interest in Vermosh cheese, both as a product and a process that will interest tourists, will benefit female employment.

Self employment and entrepreneurship has been seen as a solution to economies in transition, however, sometimes the rural economies are overlooked as in post-communist regions such as Hungary; this should not be the case in the Shkodra Region (Momsen & Timár, 2005). In fact, a focus on the rural community within a tourism context provides an opportunity for cultural expression, employment regeneration while acting as a developmental vehicle (Hall, 2000). It is also a way to encourage eco-tourism while supporting the local economy (Barkin, 2002). Proper planning for such local development should allow the Shkodra Region to avoid the "negative model" of such tourist Meccas as Thailand where a clear strategy for handling this influx of tourists is

lacking (Pleumarom, 2002). In other words, strategies should be developed that consider the ecological footprint of such tourism (Hunter, 2002) and partner with government and local tourism entities (Herbig & O'Hara, 1997). To encourage this green perspective, small business owners need to be educated to the pitfalls of a primarily economic focus to the development of tourism as an industry (Tzschentke, Kirk & Lynch, 2004). In this aspect, the local educational institutions and the state will play an important role in addressing the immediate problem of tourism industry employee training. In the mean time, Shkodra women both as artisans and as budding entrepreneurs will continue to reflect the hospitality and the rich traditions of the Albanian culture.

CONCLUSION

Albania's climate and location make it an area ripe for investment, particularly in the tourism industry. Tourism has been shown to be successful for economies in transition like that of the Shkodra Region. However, basic infrastructure modernization and investment in education is paramount to developing tourism, which will in turn support the other industries, including the region's unique artisan skills. Thus, the attention of international entrepreneurs in conjunction with local entrepreneurs must be developed.

Given the key role of women in both the family and the maintenance of cultural traditions, a particular focus on the utilization of women as a catalyst to local tourism is important. To assist these small businesses a mass tourism strategy must be enacted in conjunction with a more rural niche form of tourism, one supporting the other. In either case, training in the areas of hospitality, leisure, tourism and market research will be essential ingredients to success. Such training will increase their competence to compete in the global tourism economy, allowing them to capitalize on their language skills and the central and environmentally rich location of their region. Thus, a focus on women in agro-tourism and family tourism appears to be a natural fit.

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COMBINING STRATEGIC MANAGEMENT AND INTERNAL CONTROL PROCESSES: A RECIPE FOR ENTREPRENEURIAL COMPETITIVE ADVANTAGE

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ABSTRACT

This article assembles a variety of practical techniques into a systematic strategic management framework suitable for small public companies dealing with mandated financial reporting internal control compliance provisions of the Sarbanes-Oxley (SOX) Act. A strategic process model provides small businesses with consistency to successfully fulfill continual SOX Section 404(a) internal control assessments and Section 404(b) external audit attestation assessments. This flexible framework also complements entrepreneurial competitive advantages with customers, vendors, and investors, and reduces financial fraud and litigation risk.

INTRODUCTION

Innovation, creativity, customer value, and reasoned risk-taking shape successful entrepreneurial business models. However, prosperous small businesses entrepreneurs ultimately encounter complexities of organizational structure and functional support processes that contribute to creative competitive advantages. Nearly 5,000 small businesses that have taken on regulatory responsibilities through public stock offerings now face challenges of conducting internal assessments of their financial reporting internal controls to comply with Sections 404(a) and (b) of the 2002 Sarbanes-Oxley Act. These small public firms with less than $75 million in market capitalization have begun to fulfill Section 404(a) requirements during 2008 by reporting internal assessments of their financial reporting internal controls in their annual 10-k reports to the SEC. An external audit report attesting to the propriety of financial internal controls will appear in small public company financial reports after December 15, 2009 ("SEC Extends 404(b) Compliance", 2008).

This article attempts to enlighten entrepreneurial executives encountering SOX 404 reviews about competitive advantages emanating from a sound financial control function that augments entrepreneurial growth by strengthening customer loyalty and employee satisfaction, reduces government oversight, improves internal productivity, cuts infrastructure costs, lessens working capital requirements, and supplies reliable financial disclosures for managerial planning and

decision-making. This article may also be of interest to private entrepreneurs contemplating future public stock offerings.

SOX Section 302(a)(4)(A) establishes responsibility for establishing and maintaining internal controls with chief executives and principal financial officers of publicly traded companies. This article presents a flexible strategic management process approach to leading managers of small public business to coordinate SOX 404(a) internal control appraisals, supervise internal control advancements and lower SOX 404(b) external attestation costs to enhance economic value for shareholders and reduce potential litigation risk of top executives required to certify the material truthfulness of public financial disclosures under the provisions of SOX Section 302(a)(2).

SOX SECTION 404 SMALL BUSINESS IMPLEMENTATION BACKGROUND

Former SEC chairmen Paul Volcker and Arthur Levitt have asserted that SOX 404 costs exemplify long-term investments in corporate responsibility that strengthen market efficiencies and reduce market risk (Volcker and Levitt, 2004). A majority of chief financial officers and senior controllers believe small market cap firms that meet SOX 404 standards improve investor perceptions about a business (The Ohio Society of CPAs, 2007). Above-average market gains have been associated with firms possessing strong financial internal controls, implying that perceived investor benefits from enhanced internal controls may outweigh cost concerns (Reilly, 2006).

A variety of external stakeholders have defended SOX 404 compliance for upgrading confidence in financial statement reliability. Cited benefits include reduced financial statement fraud risk, enhanced audit quality, increased investor confidence in financial data trustworthiness, and a reduction of shareholder litigation. While external auditors cited nearly every Standard and Poor 500 member with "material weaknesses" in financial reporting internal controls in 2006, only eleven companies reported similar weaknesses in 2007, implying that SOX 404 regulations had drastically improved financial statement reliability ("Material Weaknesses", 2008).

HIGH-QUALITY INTERNAL CONTROLS REINFORCE ENTREPRENEURIAL COMPETITIVE ADVANTAGES

A recent survey of nearly 500 global banking executives identified primary components of an effective risk management culture involves personnel at all organizational levels, a risk management support function, and well-organized internal control processes and audits. The same survey reported that over 80% of executives perceive enterprise risk management as a competitive advantage (PR Newswire, 2009). Small entrepreneurial enterprises can realize several competitive opportunities from employing systematic financial internal controls.

Improved Customer Relationships

Robust financial internal controls can ensure accurate and timely billing and cash collections from valued customers. Consistent internal control procedures nurture a business image that cultivates customer confidence and maintains long-term positive relationships with clients.

Moreover, monitoring customer accounts reduces bad debt losses, recognizes dependable customers for future sales promotions, and identifies consumers that maximize sales and profitability. Good financial controls institute consistent collection policies that consider unique customer circumstances but also specify actions and timeframes for collection actions to commence.

Improved Vendor Relationships

Financial controls also permit precise and timely vendor payments that preserve healthy credit dealings with key resource suppliers. Timely payments improve profitability by maximizing available vendor discounts that reduce financing costs. Furthermore, internal financial controls designate proper personnel to authorize and verify credit purchases and approve payments, thereby increasing managerial accountability while reducing financial fraud risk from misappropriation of business resources.

Reduced Government Oversight Costs

Adequate financial controls upgrade fulfillment of payroll and payroll tax responsibilities to government authorities correctly and as scheduled. Employee payroll calculation adjustments should fall, thus boosting productivity, employee confidence, and decreasing preparation costs. Upgraded payroll functions decrease risks of tax penalties, publicly disclosed tax liens that might negatively influence external party perceptions of company operations, and intensified scrutiny from tax officials of future tax filings.

As previously mentioned, positive financial internal controls can also moderate potential litigation risks of top operating and financial executives required to certify the accuracy of public financial statements under the provisions of SOX Section 302.

Improved Cash Management and Lending Opportunities

Accelerated cash collections, as well as timely vendor and payroll tax payments, permit small businesses to supplement their organizational cash flows. These financial control outcomes will ease working capital requirements, lower financial risk of loan covenant violations, and advance prospects for future financial options to fund future entrepreneurial initiatives to enter new markets or feature new product/services lines.

Effective Executive Decision-Making

Strong internal controls result in reliable financial information for small business executives to identify significant operational variances and quickly take corrective actions. As small business owner/managers confront more internal and external complexity, the greater the importance of dependable financial data to rapidly respond to changing competitive circumstances. Reliable financial statistics also provides entrepreneurs with confidence in the accuracy of sales and cash flow forecasts emanating from strategic management planning.

Improved External Stakeholder Relationships

An organized, strategic process approach to establishing and monitoring financial controls can also be beneficial in maintaining positive dealings with external stakeholders. Reliable financial information allows business executives to share their views of current and future operational performance boards of directors, major lenders, and company shareholders. Entrepreneurial managers can build trust, enhance their public image, and convey conviction that their vision of future entrepreneurial expansion will further customer values that will ultimately produce operational and financial success for employees, executives, and stockholders.

THE CASE FOR A SMALL BUSINESS INTERNAL CONTROL STRATEGIC PROCESS

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) was originally formed in 1985 by five major U. S. accounting and financial associations to study causal issues of fraudulent financial reporting. Commission members represent leaders from private industry, public accounting, investment firms, and the New York Stock Exchange. As part of its agenda, the Committee has advocated strong internal controls as a deterrent to financial fraud. COSO and PricewaterhouseCoopers LLP, an accounting industry leader in SOX 404 attestation and consulting services have stressed the importance of a process approach to financial risk assessment and planning (PricewaterhouseCoopers, 2007).

Nevertheless, some experienced SOX 404 companies remain organizationally fractured by various cross-functional teams supervised by financial managers conducting redundant internal control implementation, testing and documentation procedures (Marcello, 2006). This disconnected structure can result in higher compliance costs, greater financial risk, and diminished opportunities to integrate internal control progress to complement entrepreneurial market objectives.

Table 1: Six Processes of Strategic Management	
1.	Vision and Mission Statements
2.	Key Stakeholders
3.	Goals and Objectives
4.	Strategic Actions
5.	Strategy Implementation
6.	Feedback Analysis

Applying strategic management principles to changing SOX 404 circumstances, internal control changes, and assessment feedback can boost internal control effectiveness by emphasizing customized agendas that positively contribute to several entrepreneurial outcomes previously mentioned.

PROCESS ONE: ESTABLISHING INTERNAL CONTROL VISION AND MISSION STATEMENTS

A vision statement succinctly encapsulates the ambition of an organization articulated by top management. An internal control vision statement institutes fundamental principles that underlie internal control operations. Vision statements succinctly communicate to all constituencies the reasoning behind integrating internal control compliance features into every operational category.

Internal control vision statements might view internal control compliance costs as long-term investments that meet corporate responsibilities to investors, creditors and employees. Another approach could relate compliance activities with lowered costs of capital and strengthened financial growth opportunities.

Table 2: Process One: Establishing Internal Control Vision and Mission Statements
Vision Statement
Internal Control Costs = Long-Term Investments in Corporate Responsibility to Key Stakeholders
Improve Investor Confidence
Reduce Costs of Capital
Strengthen Financial Statement Reliability
Lower Fraud and Financial Statement Risk
Expand Financial Growth Opportunities
Mission Statement
Speed and Accuracy of Transaction Processing

Table 2: Process One: Establishing Internal Control Vision and Mission Statements
Truthful Financial Reporting to Internal and External Stakeholders (Relevant and Material to Company
Activities)
Risk Assessment Timing and Effectiveness
Control Environment
Internal Decision and Communication Styles
Adherence to COSO Internal Control Principles

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) small business internal control guidance alternatively suggests that a vision statement spotlight achieving high levels of financial statement reliability through providing reasonable assurance that such statements are free from material misstatement and assist management decision-making. This vision would spotlight accurately reflecting material business transactions, processes and events in financial statements and disclosures (Committee of Sponsoring Organizations of the Treadway Commission, 2006).

COSO also presents guidance that could be employed in a mission statement to address the existing internal control environment. An internal control compliance mission statement would accept informed judgments regarding current levels of risk assessment, documentation standards, control environments and activities, monitoring systems and communication channels for effective decision-making. COSO further breaks down these fundamental internal control characteristics into twenty principles that can be detailed in corporate mission statements as original norms for evaluating future internal control success (COSO, 2006).

PROCESS TWO: IDENTIFYING INTERNAL CONTROL STAKEHOLDERS

The internal control compliance environment encompasses various stakeholders that small business executives and boards should consider prior to forming internal control strategies. Senior management can judge each of these SOX 404 external entities on the basis of their potential opportunity or threat to long-term internal control effectiveness and integration.

Legal internal control enforcement rests with the SEC aided by audit standards prepared by the privately funded PCAOB and followed by its registered audit firms. The PCAOB has aggressively centered on internal control audit efficiencies during inspections of registered accounting firms. The board disseminates internal control guidance to small businesses through public forums throughout the country ("SEC Announces Next Steps for SOX Implementation", 2006). The American Institute of Certified Public Accountants (AICPA), state accounting associations, and internal control consulting firms offer further resources for gathering knowledge of current internal control regulatory matters. Finally, COSO small business internal control guidance supplies excellent

reference information and examples of internal control issues ("SEC Announces Next Steps for SOX Implementation", 2006).

Table 3: Process Two: Identifying Internal Control Stakeholders
External Stakeholders
Securities and Exchange Commission (SOX 404 Regulation and Guidance)
Public Company Oversight and Accounting Board (Auditing Standard No. 5)
American Institute of Certified Public Accountants (Training)
State Accounting Societies (Training)
Internal Control Consulting Firms (Advisory)
COSO Small Business Guidance (Internal Missions)
Creditors and Shareholders (Cost of Capital)
Securities Trial Lawyers (Shareholder Litigation)
Insurance Companies (Litigation Insurance Premiums).
Federal and State Legislatures (Possible SOX Modifications)
Foreign Stock Exchanges (International Stock Listings)
SOX 404 Software Developers (SOX 404 Assessments)
Colleges and Universities (Entry-Level Accountants, Consulting, and Training)
Internal Stakeholders
Board Members (Audit Committee)
Senior Executives
Financial/Accounting Personnel
Internal Audit Staff
Internal Control Project Managers (SOX 404 Implementation and Assessment)
Information Technology (Data Collection and Security)
Tax Personnel/Advisors (Adequacy of Tax Disclosures)

In a 2007 survey conducted by the Center for Audit Quality, 76% of polled investors conveyed positive attitudes towards requiring companies to evaluate their internal controls and for external attestations to their effectiveness ("Investors Oppose SOX Reform", 2007). Effective internal controls can lessen financial restatements and lower litigation insurance premiums.

Federal and state governments can influence SOX 404 compliance. For example, the U. S. Senate once introduced legislation that would have compelled the SEC to establish alternative internal control measures for public companies choosing not to adopt SOX 404 statutes (Demint & Feeney, 2006). The state of New York, along with leaders of the New York Stock Exchange and

NASDAQ, has claimed that SOX 404 costs constrain small business growth and initial public stock offerings (Lehmann, June 13, 2006). Foreign stock exchanges, notably the London Stock Exchange, actively promote

U. S. small business membership to avoid SOX regulatory burdens. Conversely, exchange markets in Japan, France, China, and Canada have adopted internal control rules similar to those enforced in the United States (Healey, 2007).

Software developers market small business programs that record, organize, manage, and retain internal control documentation for SOX 404(b) audits. Small business consulting specialists help establish and coordinate lines of authority and communications between internal control project teams. Local universities furnish entry-level accounting graduates capable of performing assessment functions. Accounting faculty may possess internal control or financial expertise for board representation or offer internal control training updates.

Internal stakeholders most directly affected by internal control developments will be senior managers, board members (particularly the audit committee), financial personnel, internal audit staff and project team members. Other departments likely to contribute to internal control reviews include information technology (information security and assessment documentation) and taxation. Tax experts can explain the effects of tax consequences on financial statement reports. Internal control project managers coordinate cross-functional teams and outside consultants, project agendas, deadlines, internal control assessment tasks, documentation confirmation, and communications throughout the organization.

Organization culture should adhere to a formal code of conduct, ethics training, ongoing review of ethical behavior, and whistleblower policies that protect employees against retribution while resolving ethical dilemmas promptly and equitably. Organization structure complexity will impact internal control testing. Straightforward centralized firms may enable substitution of some testing procedures and documentation with verbal confirmation by managers with direct oversight over particular tasks. Decentralized companies may need additional evidence to corroborate complex, multiple controls over financial decisions and transactions. Numerous operating locations, outsourced functions, and complex inventory computations may further intensify internal control testing and documentation measures.

PROCESS THREE: ESTABLISHING GOALS AND OBJECTIVES FOR INTERNAL CONTROL COMPLIANCE

Organizational goals define attainable and measurable expectations. Financial reporting internal control procedures affect strategic and financial goals by improving financial reporting reliability and operational efficiencies.

Senior management of small public firms must first decide on pursuing the overall goal of SOX 404 compliance. If management concludes that SOX 404 regulatory costs outweigh stakeholder

benefits, then a broad goal can be the avoidance of SOX 404 regulatory requirements. If this goal is pursued, several alternative objectives may be deliberated:

- Acquisition by a larger company;
- Privatization;
- Merger;
- Foreign stock exchange listing (particularly the Alternative Investment Market or AIM).

Each of these alternatives carries business risks. Acquisition or merger may reduce management control, employment, competitiveness and innovation. Privatizing can shrink prospects for outside financing. The AIM exchange represents a self-regulatory system that connects registrants with investment bank consultants, referred to as nomads, that promote the company directly to institutional investors. The London Stock Exchange attracted 129 foreign listings in 2005 compared to six new listings on the New York Stock Exchange over the same period (Lehmann, March 21, 2006).

Conversely, a foreign exchange listing may offset lower regulatory expenditures with raised perceived financial risk and increased capital acquisition costs. One SEC commissioner depicted AIM as a "casino" culture (Teitelbaum, 2007). Nomads and ensuing promoters of new stock issuances often work for the same investment firm, causing "conflict of interest" concerns for some investors. Fifty percent of the 20 largest companies that went public in the AIM exchange during 2006 traded below their offering prices by the conclusion of that year (Mollenkamp, MacDonald, and Davis, 2006).

Table 4: Process Three: Establishing Goals and Objectives for Internal Control Compliance
Goal: Avoidance of SOX 404 Compliance
Objectives:
Privatization
Selling Out
Foreign Stock Exchange Listing
Merger
Goal: Adoption of SOX 404 Provisions
Objectives:
Recruitment and Retention of Experienced Financial Personnel
Recruitment of SOX 404 Consultants
Selection of PCAOB-Registered External Auditor (Small Vs. Large Firm)
Selection of SOX 404 Software Support
Adequacy of Data Storage Capacity and Security

A variety of immediate goals should be considered by businesses accepting SOX 404 internal control provisions. Recruitment and retention of experienced financial personnel should be prioritized. Internal control consultants should convey knowledge currency and depth about SOX 404 regulatory and technological developments. Small public businesses must select an external auditor registered to perform SOX 404(b) attestations and consider both Big-Four and smaller firms. Smaller CPA firms have increased their total audit market share from 1.97% in 2001 to 5.5% in 2006, suggesting a trend of non-Big Four firms conducting more internal control audits ("Big Accounting Firms", 2007). A secure data storage system must securely house internal control test conclusions evaluated during an internal control external audit.

Long-term internal control compliance goals may stress the following subjects:

- Fraud prevention and detection system for financial statement fraud;
- Lower financial risk;
- Reduced cost of capital;
- Decreased financial restatement risk;
- Improved opportunities for external capital funding;
- Internal control integration within organizational culture;
- Enhanced internal control assessment and external audit efficiencies.

According to COSO (2006) guidance, immediate internal control objectives should relate specific company activities to the ability of the internal control system to sustain reliable and timely financial information that supports management decisions. Mechanisms for processing transactions quickly and accurately must be appraised. Accurate financial data should be reported objectively to internal and external stakeholders.

PROCESS FOUR: STRATEGY SELECTION FOR INTERNAL CONTROL COMPLIANCE

SOX 404 strategies should correlate with goals and objectives determined by top management. Strategies can be rapidly formulated via a top-down decision approach communicated by top management to lower-level managers. Conversely, bottom-up decision-making takes more time to reach consensus but encourages greater participation and goal commitment by all employees. Regardless of the decision format, strategy preparations should reveal organizational actions that will fulfill internal control goals. Senior management must adequately budget for financial, human, and technological resources necessary for successful completion of internal control evaluations.

Table 5: Process Four: Strategy Selection Issues for Internal Control Compliance
Centralized or Participative Decision Style
Internal Control Compliance Personnel Training
Conferences Between Controller, Internal Control and Financial Staff, and External Auditor
Obtaining SOX 404 Consultative Advice
Delegation of Responsibility/Authority to SOX 404 Project Leaders
Review of Financial Policies and Procedures By Senior Management, Board of Directors, and Chief Financial Officer
Explicit Code of Conduct Policies and Enforcement
Collection and Security of SOX 404 Assessment Documentation
Organization Complexity (Structure and Outsourcing)

Financial personnel can refer to a variety of internal control technical instruction. The PCAOB offers forums on auditing in a small business environment throughout the year. COSO's publication "Internal Control Over Financial Reporting – Guidance for Smaller Public Companies" describes essential principles and issues to effective fulfillment of SOX 404 rules. Online or seminar SOX 404 training can assimilate internal control goals throughout an organization.

Recurring meetings between the company controller, internal audit staff, and external audit team should foster understanding of the external audit attestation process. In a 2007 survey, 77% of internal audit leaders believed that significant outsourcing of critical functions have a moderate to very strong impact on internal audit roles and responsibilities (PricewaterhouseCoopers, September 26, 2007). Therefore, representatives of outsourced financial functions, such as payroll, should also attend these preliminary sessions to coordinate activities between company and external auditors. Internal control consultants should complement agreements between company officials and external auditors.

Internal strategies for managing internal control assessments define project assignments, deadlines, and expected outcomes to project groups after a review of SOX 404 guidance, meetings with external auditors, and discussions with SOX 404 advisors. Effective cross-functional teams unite various organizational factions into focused groups working towards common outcomes.

Authority must be resolved for each internal control team. Three different approaches can be utilized for project authority designation. Functional authority assigns functional managers, such as financial personnel, as team leaders because of their primary internal control responsibilities. One problem with this method is that outside group members may lack commitment to achieving team goals. Special project teams temporarily take away members from normal company operations to focus on internal control appraisals. This process promotes independence and speed in accomplishing desired outcomes. However, smaller businesses may not have the personnel flexibility to remove employees from critical regular responsibilities. Matrix structures delegate

authority between project administrators and functional managers. Smaller businesses with limited financial personnel might prefer either the functional or matrix concepts for directing their SOX 404 assessment teams.

Internal control risk should be adjusted in accordance with organizational complexity. Centralized supervision of financial functions could compensate for detailed standard operating procedure manuals. Decentralized authority increases chances of management overrides of company policies, thus enlarging financial risk and internal control testing measures.

Senior management, board members, and the chief financial officer should review financial policies to agree on materiality levels for specific financial reporting functions supporting business operations. Revenue recognition guidelines should receive the highest attention during internal control assessment. Corroborating evidence of explicit ethical expectations, training, monitoring, and investigations can influence financial risk judgments and internal control testing levels.

PROCESS FIVE: IMPLEMENTATION OF INTERNAL CONTROL COMPLIANCE STRATEGIES

Faulty strategic implementation causes failure to reach goal expectations. COSO SOX 404 small business guidance states that internal control implementation should capture, process, and communicate information needed for effective financial reporting and internal control (COSO, 2006). Effective plan implementation requires constant reinforcement from top management about goals, strategies and projected outcomes. Effective monitoring of implementation progress requires frequent review of data and feedback from project groups and leaders.

Internal control consulting firm Lord and Benoit lists ten issues that could significantly threaten small business internal control compliance implementation (Benoit, 2007):

- Accounting and disclosure controls;
- Treasury controls (stock, debt, investments, derivatives, cash);
- Competence and training of accounting personnel;
- Control culture;
- Control design or lack of compensating controls;
- Revenue recognition;
- Financial closing process;
- Inadequate account reconciliations;
- Information technology;
- Consolidation, merger, and intercompany accounts.

Table 6: Process Five: Implementation of Internal Control Compliance Strategies
Risk Assessments of Financial Information Processing and Recording
Testing and Documentation Activities
Sufficiency of Data Storage Capacity
Installation and Capability of Internal Control Compliance Software

Risk assessments determine testing and documentation levels to reasonably assure satisfactory internal control adherence. Risk assessments of financial information processing and recording should be based upon materiality judgments of each operating activity relative to reported financial information and the degree of restatement risk from fraudulent financial statements. If multiple steps are required to properly record and report a transaction type, the most critical function should receive highest priority for testing and supporting evidence. Increased detail should complement recorded transactions of top selling products. Tax professionals should confirm tax disclosure adequacy in financial statements disclosures.

Another key implementation issue concerns installation and adequacy internal control compliance software. This specialized software associates tasks with responsible personnel, automatically e-mails project deadlines, and updates progress and completion of essential duties (Loftus, 2005). Internal control software should have adequate storage capacity to thoroughly preserve accurate assessment support documentation. Lastly, compliance software should also automate reconciliations, identify exceptions for management scrutiny, and support segregation of duties (COSO, 2006).

Senior managers should verify the level of internal control regulatory understanding of information technology specialists to competently execute compliance assessment requests (Johnson, 2006). Information technology personnel should also prepare to substantiate information security plan effectiveness to external auditors. Documentation and data storage software should be appraised throughout assessment progress. Only personnel directly involved in internal control implementation and oversight should have data access. Internal control project leaders should certify accuracy and completeness of internal control assessment reports.

PROCESS SIX: ANALYZING FEEDBACK FOR FUTURE INTERNAL CONTROL EFFICIENCIES

Recent surveys have revealed a greater than 20% decline in second-year SOX 404(b) audit fees and further reductions in third-year SOX 404 compliance costs (Healey, 2007). According to the Financial Executives Institute, auditor fees for internal control attestations dropped by 5.4% during 2007 (Burns, 2008). SOX compliance costs are estimated to rise by only 2% in 2008, suggesting

shifting company priorities pertaining to internal control practices (Pessin, 2008). How can small businesses follow suit to realize similar internal control efficiencies?

Audit committee board members should initially examine internal compliance assessment reports and subsequently counsel the entire board of directors about assessment conclusions and forthcoming control adjustments. The board should charge senior management to lead internal control improvement administration throughout the organization. Clearly communicating change expectations and closely scrutinizing ensuing actions increases probabilities for long-term improvements in internal control organizational culture. Audit committee and board members should devise goals for future internal control audits, thus renewing the strategic management process in an orderly fashion for future deliberation and updating.

Table 7: Process Six: Analyzing Feedback for Future Internal Control Efficiencies
Assessment Reports Filed with Audit Committee Members
Consultations With Board of Directors
Clear Organizational Communications by Top Management Concerning Internal Control Corrections and Improvements
Rigorous Monitoring of Internal Control Adjustments
Review/Revision of Prior Vision/Mission Statements and Goals/Plans for Future Internal Control Audits
Consideration of Real-Time Audit Software System
Emphasis of Internal Control Value Throughout Organization Culture and External Stakeholder Environment

Revised audit plans should indoctrinate annual internal control risk assessments into company risk management practices. By year three, internal control compliance attention may rebalance with traditional internal control activities through refined identification of critical control functions, condensed control populations, and greater reliance on internal control findings by external auditors. Additional internal control knowledge and experience can mitigate reliance on outside internal control consultants ("Internal Audit Departments 'Return to Roots'", 2007). Installation of real-time auditing software can advance audit and fraud detection capabilities that trim audit fees.

Effective feedback management ultimately assimilates constant internal control observation and change into overall operations to complement superior organizational performance. Marcello (2006) proposes four cultural phases for long-term internal control strategic effectiveness:

- Fragmented - Functional project predominance;
- Team-based – Internal control headed by a chief compliance officer;
- Integrated – Compliance procedures absorbed into existing operations;
- Embedded – Internal control principles guide all aspects of corporate culture.

SUMMARY AND CONCLUSION

Initial internal control assessment and attestation activities introduce internal control upgrades that can diminish financial risk and complement entrepreneurial competitive advantages. The strategic management framework presented in this paper outlines a disciplined process to systematically plan, implement, and analyze internal control advancements that elevate financial statement reliability for internal and external decision-making.

The six processes of strategic management presented in this article can be adapted to any business model and environment. Informed judgments of top managers, internal control and financial specialists form the cornerstone of an orderly internal control strategic management process. Interpersonal qualities such as vision leadership, clear and frequent communications among all vested parties, and objective consideration of feedback contribute to the ultimate emergence of an superior internal control organizational culture that protects company assets and promotes reliable financial reporting.

Rather than being viewed as an operational impediment, high-quality financial internal controls represent essential fundamentals of efficiently managed organizations that improve customer value, vendor relationships, government oversight, shareholder communications, and internal management decision-making that can free entrepreneurial executives to pursue innovative strategies that address long-term customer and stakeholder expectations.

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LEGAL INSIGHT DECISION MAKING FOR SMALL BUSINESS AND ENTREPRENEURS: A JUDICIOUS APPROACH

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ABSTRACT

This paper addresses the gaps in legal insight and decision-making for small business and entrepreneurs and describes the implications of correlative judicial remedies for these issues. Summary findings of empirical studies of preventable problems faced by business are juxtaposed against a discrete analysis of relevant United States Supreme Court decisions involving these same business interests. Finally, a more judicious solution to improve legal insight and decision-making is proposed; this alternative model, called a Legal Audit, is advanced to first elevate legal insight and decision making, and then to diagnose and address flawed legal practices which create significant legal problems. The paper ends with a call for further inquiry of sustainable legal decision making and minimal acceptable standards for the concept LIDM or Legal Insight Decision Making.

INTRODUCTION

Each year the United States Supreme Court (USSC) issues a limited number of Writs of Certiorari. This action constitutes initiation of the legal process that requests a lower court to deliver the record in the case the USSC has accepted for review. The USSC accepts and decides only a finite number of cases and remarkably few of these involve business interests. For example, in each year from 2005-2009, the USSC docket heard or will hear as few as 63 cases and as many as 74 cases; but of these cases, only a baker's dozen directly affect business interests. Knowledge of this finite universe of USSC cases that affect business interests is power; in fact, these select cases provide rich lessons to the wise and wary.

BACKGROUND AND LITERATURE REVIEW

Amid growing concern that even the wise and wary are not savvy to the lessons of the USSC decisions affecting business (Cutler, 2003; Hemingway& Maclagan, 2004) nor even to the need to comply with underlying laws and regulations (Rondinelli, 2007) some have concluded that the failure to seek and access information (Roth, 2005) does inhibit firm performance and can indeed impede success. Researchers have observed that companies of all sizes are adept at developing and

implementing mission statements (Gumbus& Lussier 2006), but this does not translate to ability to develop awareness of legal issues and consequent legal insight decision making.

Minority and non-minority entrepreneurs, whose likelihood for failure exceeds the average failure rate for new businesses (Kaplan, 2003; Kuratko, 2005; Mendoza, 2007) are in accord with this perspective. Indeed, the term "entrepreneurial cognition" aptly describes the process of overcoming ignorance and doubt to find opportunity to act and make decisions (Shepherd, et al 2007) such as should be made in the arena of legal issues and practices, without regard to firm differences. In fact, decision making which involves the owners and managers of the firm, especially in the legal arena, can lead to conflict, as aptly noted by family business scholars, (Eddleson, Otondo & Kellermanns, 2008; Brigham, DeCastro & Shepherd, 2007; Steier & Ward, 2006) and the field for future research is rich (Heck, Hoy, Poutziouris & Steier, 2008); although the available data and published research on judicially affected legal issues is less so.

The opportunity to act and make beneficial decisions affecting legal issues does not rest solely in the hands of the firm's legal counsel; indeed, the majority of small businesses seek legal counsel in a reactionary rather than proactive manner. Even small business academic gurus, Hornsby, Kuratko, Naffzinger, LaFollette and Hodgetts in a co-authored seminal study, "The Ethical perceptions of small business owners: A factor analytic study" published in 1994 and using a 16 item questionnaire developed by Longenecker, McKinney and Moore (1989) equated legal decision-making with ethics rather than with legal knowledge (Hornsby, Kuratko, Naffzinger, LaFollette & Hodgetts, 1994; Longenecker, Moore, Petty, Palich & McKinney, 2006). The literature thus describes and characterizes the legal decision as an ethical decision; though whether the decision is made by the small business owner or the hired hand legal counsel, legal decisions are not, in fact, related to ethical perceptions. Further, most small firms do not retain in-house legal counsel, but resort to out-sourcing formal legal advice as needed or when a perceived legal issue arises.

While scholars note strategic planning is the optimum weapon to enhance organizational performance (Ensley, Carland & Carland, 2003), legal issues strategic planning is sometimes omitted from the mix of planning elements. In studies of nascent business development, the formation of the legal entity or selection of legal form of business may figure as merely a step in development (Fiore, Lussier, 2007). Studies of small businesses that engage in formal and informal planning and the importance of planning is presumed and validated by many scholars (Allred, Addams & Chakraborty 2007). However, there is disagreement upon the dimensions of the planning and the inclusion of all the fundamental business functions (especially the legal function) in planning. In the Allred study, the ranking of legal planning was near the bottom for both formal and informal planning. Other scholars measuring internal and external considerations of planning, in particular strategic planning identify only a very low Pareto analysis result for each of the legal factors measured: legal environment and legislation regulation (Hodges & Kent, 2007). Whether the study involves home-based businesses (Bardwell, Spiller & Anderson, 2003) or studies of business success factors, including financing and planning even with boot-strap methods (Van Auken, 2003), these studies often tangentially shed light on the related legal issues; but do not focus on the risk of

consequential legal remedies.The lack of legal insight and failure of effective legal decision making can be deduced from the increase in small business lawsuits, arbitrations and bankruptcies- all of which are on the rise according to the statistics available via BLS and according to many insightful researchers (Gaskill, Van Auken & Manning, 1993; Lussier, 1995; Palmer, Andaleeb & Joyner, 2005/2006; Carter & Van Auken, 2006).

Even seasoned, knowledgeable researchers and academic proponents of business models may omit the legal component in research and conceptual theoretic; in fact, no legal functions were included in a proposed comprehensive review of core components of a business model and no reference to legal matters were identified in the definitions of business models in a seminal article about the creation of an empirical model to test theories of guidance to achieve sustainable advantage (Morris, Schindehutte, Richardson, & Allen, 2006). Thus, a review of the literature that addresses these various issues reveals that relatively few legal issues matters or studies have been reported in the literature of small business journals unless one considers topic specific articles, or studies reporting client satisfaction with bankruptcy legal representation (Palmer, Andaleeb & Joyner, 2005/2006) or other topic specific reviews concerning regulatory or general category legal issues.

Identifiable legal issues affecting new ventures are likely to include matters like business format, intellectual property, liability, regulation, contracts, tax, employment, finance and real property (Malach, Robinson & Radcliffe, 2006). In a comprehensive survey of 292 legal clinic clients who were generally in planning or pre-start up phase, analysis of the type of business rather than the legal issue was the focus of the study (Malach, Robinson & Radcliffe, 2006). This study targeted the stage of the business development as a distinctive factor in legal issue identification; it reveals significant useful information regarding the type of issues identified, but opts to use a proxy of frequency to rank importance of those legal issues. The attempt to quantitatively rank the relative importance of the legal issues is confined to new ventures and based upon frequency, rather than seriousness of consequence or risk of the legal decision (Malach, Robinson & Radcliffe, 2006).

Though identification of important legal issues has been the subject of several studies (Heriot and Huneycutt, 2001) as noted by Malach, et al, the literature might lead some to conclude that while distinct legal issues are the subject of scholarly study, those studies omit any cognitive recognition of a connection with the judicial remedies imposed by the USSC in its fine series of legal decisions affecting business. Indeed, the relevancy of legal issues to new ventures and the rank by frequency that the legal issue arises (Malach, Robinson and Radcliffe, 2006) does not draw any conclusions about the judicial remedies imposed upon legal decisions made by firms, small businesses and/or entrepreneurs. Over a period of several years, the author has used simple questionnaires to elicit responses from business owners and managers, MBA students, SBI students, academics, lawyers and entrepreneurs to gauge legal knowledge on business related legal issues within key USSC and other high or key court decisions (for years 2004, 2005, 2006, 2007, 2008, 2009). As will be seen, it appears that knowledge of recent USSC decisions affecting legal decision

making and which can provide legal insight to entrepreneurs, business owners and managers is hiding in plain sight.

This paper fills a gap in the literature of analysis of key legal issues by identifying the legal issues that create significant problems to business success and describes correlative judicial remedies to those legal issues. This paper proposes a logical next step in the development and examination of a new conceptual body of business related legal, ethical and regulatory matters; the concept called LIDM, Legal Insight Decision Making.

METHODOLOGY

The author, utilizing information from previous case studies which included in-depth interviews with business owners and managers, created a set of revised questionnaires to determine generic respondents' pre-knowledge of key legal issues. These questionnaires include: Top 25 Legal Issues Legal Audit© tool, Top 3 Survey Tool, Small Biz and Entrepreneurs Survey; these are included in the appendices. Respondents were not randomly selected; instead, they were voluntary participants in legal seminars, academic meetings, MBA students, undergraduate business students, business consulting clients, economists, entrepreneurs, or others seeking information about key business related USSC decisions and related legal issues. Except for the business consulting clients, no demographic or firm related data was gathered. Key legal issues were drawn from the following topics: Agent and Principal law, Arbitration, Bankruptcy, Contracts and Collections, Damage(s) Control, Embezzlement, Eminent Domain, Employment Law, Fraud, Independent Contractors, Intellectual Property protection, Privacy, Sarbanes-Oxley Rules, SPAM law, Tax Law, Tax Matters and Liability, Trademarks and Trade Secrets, Truth in Lending (TILA), Regulation "Z". Questionnaires, surveys, focus groups and consulting inquiries using the Top 25 Legal Issues Legal Audit© tool, Top 3 Survey Tool, Small Biz and Entrepreneurs Survey were utilized to collect information and to determine general legal topic knowledge.

For example, in the Top 25 Legal Issues Audit©, business owners, managers, consultants, economists, entrepreneurs and others review the integrated components which are necessary for healthy legal status of any business entity. The Top 25 Legal Issues Audit© tool is a checklist of items ranging from compliance matters, to collection and contract suggestions which should be in place for every business. The twenty five issues pertain to all business forms, and most items also pertain to non-profits. This tool is useful to raise awareness of specific legal practices which should be in use to maintain legal health and acts as a diagnostic for legal errors and omissions. It is useful both as a teaching device to raise awareness, and a list of best practices for model legal health.

Exhibit A: Top 25 Legal Issues Audit©	
1.	Business License on File in All Jurisdictions in Which Doing Business
2.	Proper & BEST Legal Form Of Doing Business& Yearly Compliance [Sole Prop/ Partnership/ LLC/S-Corp/C-Corp]
3.	Federal/ State/ Local Tax Compliance
4.	Multi-jurisdictional Tax Compliance
5.	Insurance Policies: Liability & Umbrella
6.	Worker's Compensation
7.	Health Insurance
8.	Contracts with Employees customized
9.	Contracts with Partners customized
10.	Contracts with Suppliers/Vendors customized
11.	Office/Warehouse/Other Property Lease Contracts customized
12.	Equipment Lease Contracts customized
13.	Current Licenses or Compliance Records For Specialty Workers or IKs Government Regulations Posted On Site For OSHA/ABC/Etc.
15.	Intellectual Property is Recognized and Registered
16.	Pensions, Disability, Other Benefits
17.	Arbitration Clause & Collections Policy Clearly Stated On All Contracts
18.	"As-Is", Warranties, Guarantees etc. Clearly Stated On All Sales Invoices
19.	Facilities Accessible To Handicapped
20.	Facilities in Good Repair/No Dangerous Conditions
21.	Calendar Of Dates For All Required Tax Filings & other “compliance” filings
22.	Bank Accounts and Financial Data Up To Date and regularly audited
23.	Partnership/Key Person Insurance
24.	Disposition of Business Assets Written Plan Exists In The Event Of Emergency or Death
25.	Up To Date Will on File with Attorney with Accurate Description of Directions for Disposition of Business

Perceived problems facing business owners are likely to range from macro (the economy) to micro (the collection of past due accounts), and there may be cyclically popular problems of supply, sales, cash-flow and innumerable other problems faced by businesses no matter what size or industry.

A short questionnaire called Top 3 Survey Tool was developed to aid identification of top problems facing business owners; the resulting topics solicited from the use of the Top 3 Survey

Tool were culled to reveal the top legal content problems. The resulting topics then were analyzed in conjunction with relevant USSC decisions on those topics.

Exhibit B: Top 3 Survey
The top three problems facing business owners: [a]_____ [b]_____ [c]_____ The top three reasons entrepreneurs/businesses ARE successful**:** [a]_____ [b]_____ [c]_____ Three preventable problems for small business: [a] _____ [b] _____ [c] _____

CORRELATIVE JUDICIAL REMEDIES

As a result of these initial questionnaires, common flawed legally related business practices capable of harming businesses were identified and the legal insight decision making opportunities requiring knowledge could be organized. The key knowledge factors for each topic generated an alpha legal topics chart and those in turn could then be related directly to legal decisions (primarily USSC decisions) on those topics.

Exhibit C: Table of Sample Issues and Cases	
Issue Case	
Arbitration Vaden v. Discover Bank	
Bankruptcy United States v. Galletti	
Contracts and independent contractors Estrada v. FedEx Ground	
Embezzlement & Fraud Stoneridge Investment Partners v. Scientific-Atlanta Inc.	
Appendices: Surveys	
Small Business and Entrepreneurs Survey	
[T]/[F]	Arbitration clauses permit litigation in court.
[T]/[F]	Bankruptcy permits full discharge of debts.
[T]/[F]	Contracts w. usurious Collections policies are void.

Exhibit C: Table of Sample Issues and Cases		
[T]/[F]	Damages cannot be limited or capped.	
[T]/[F]	Embezzlement is the most prosecuted white collar crime.	
[T]/[F]	Fraud/Forgery/Falsification is on the rise.	
[T]/[F]	Regulation "Z" prohibits undisclosed fees to be charged to credit card holders.	
Legal Issues Knowledge Survey questions & Response Scale: [0 = None/Low to 5 = Strong/High]		
1.	My knowledge of uses of Arbitration clauses in contracts is:	0-1-2-3-4-5
2.	My knowledge of recent USSC decisions affecting business practices in employment law & bankruptcy is:	0-1-2-3-4-5
3.	My understanding of anti-SPAM law and practice is:	0-1-2-3-4-5
4.	My understanding of the Federal Sentencing Guidelines is:	0-1-2-3-4-5
5.	My knowledge about Intellectual Property protection for small business and entrepreneurs is:	0-1-2-3-4-5
6.	The likelihood of embezzlement becoming an issue in most businesses is:	0-1-2-3-4-5
7.	For most businesses, I believe Risks of Marketing via email and running afoul of Anti-SPAM laws is:	0-1-2-3-4-5
8.	The benefits of filing for Bankruptcy protection in 200X, compared with pre-2005, are:	0-1-2-3-4-5
9.	The likelihood of a local economic empowerment agency taking private land to turn over to another private entity is:	0-1-2-3-4-5
10.	The effect of USSC NY & MI wine industry decision about importing wine in my state is:	0-1-2-3-4-5
SPAM SURVEY		
1.	All 50 States have criminal Anti-SPAM laws-	[T]/[F]
2.	Over 80% of inbound messages to consumers are SPAM-	[T]/[F]
3.	Unsolicited E-mail with false transmission information is criminal in which states?	
4.	To date there has been no successful Prosecution of "Kingpin" Spammers sending Fraudulent Bulk messages-	[T]/[F]
5.	"Misdemeanor" SPAM rises to "Felony" SPAM under your STATE law if: [a]_____ [b]_____ [c]_____	
6.	Under the Federal CAN-SPAM Act, any State Anti-SPAM laws relating to falsity or deception are pre-empted.	[T]/[F]
7.	Anti-SPAM laws provide for both civil and criminal penalties.	[T]/[F]
8.	Private parties may institute legal action under Anti-SPAM laws.	[T]/[F]

Exhibit C: Table of Sample Issues and Cases		
9.	Under state statutes, Out-of-state SPAMMERS cannot be prosecuted.	[T]/[F]
10.	Penalties include: X___ jail time: Y___$$$	
Wage Law & Overtime Survey		
11.	Under the Federal Overtime rules, only hourly workers are entitled to overtime pay.	[T]/[F]
12.	Flex timers, managers or administrators working from home are exempt from overtime pay laws.	[T]/[F]
13.	Union employees are covered under the Federal Wages & Overtime rules.	[T]/[F]
14.	Independent Contractors are exempt from Overtime Pay rules.	[T]/[F]
15.	Penalties MAY include: X___jail time: Y ___$$$Fines Z ___Back wages for up to 2 prior years	
Wage & Hour Law Changes Survey		
Federal mandates for overtime pay have created the latest "class action" vehicle of choice in business law. Unintentional failure to pay overtime wages is corrected by civil suit- BUT intentional failure to pay overtime may bring punitive damages & jail time. Q. Who is entitled to Overtime pay? Response:		
Eminent Domain Survey		
16.	Under the 5th Amendment, Eminent Domain may only be exercised by the States.	[T]/[F]
17.	Eminent Domain permits taking of Private Property for public use upon payment of just compensation.	[T]/[F]
18.	Kelo v. City of New Londonpermits only a very narrow interpretation of "public Use".	[T]/[F]
19.	States may alter Eminent Domain rules.	[T]/[F]
20.	Private companies may be sued if they fail to put private property obtained by eminent domain to a promised use.	[T]/[F]

As is evident in Exhibit C, the very issues identified as problematic are the same issues presented to the high court under the writs of certiorari. For example, cases involving arbitration, bankruptcy, contracts have been selected and distinguished by USSC recent decisions and provide opportunity for legal insight decision making. In the following section, a select few topics will be reviewed (Arbitration, bankruptcy, contracts and independent contractors, embezzlement and fraud) and the judicial case in point is described to illustrate the Legal Insight Decision Making model.

LEGAL INSIGHT DECISION MAKING

Arbitration

Arbitration in lieu of civil litigation is favored in federal law and this deference to arbitration has been the most pervasive change in business practice in the last decade. The status of the "Arbitration" clause in contracts, as well as strategic use of the arbitration clause by big business, was noted by academic scholars at the turn of the century (Bardwell, 2001) to mark a new strategic defensive posture by lending and credit institutions. The revelation of this posture was evident due to the requirement of the federal Privacy Act which requires such institutions to annually disclose terms and conditions of the lending/borrowing relationship via mailing of an annual Privacy Notice to its customers.

Close reading of Privacy Notice Disclosures reveal that beginning in the early 2000's, arbitration clauses were regular conditions imposed as conditions of borrowing and lending by most US financial institutions. This effectively minimized costs and risks to lending and credit institutions by automatically affording the manifest protections of arbitration. The obvious benefits of arbitration include: choice of forum and choice of arbitrator to resolve the dispute by the lending institution; no jury; no appeal; no judicial precedent; and, until the Supreme Court ruled in Green Tree v. Bazzle, no class actions in arbitration. Furthermore, the Federal Arbitration Act (F.A.A. 9USC § 1 et seq.) pronounces, and federal court and USSC have agreed, that arbitration clauses are valid and preferred under law; that arbitration is favored over litigation and that arbitration can be compelled where there is a valid arbitration clause. Thus, by employing the legal tactic to force arbitration as a condition precedent to obtaining financing, the entire system of civil litigation was effectively flat out removed as an option to resolve all disputes related to financing by the lending and banking industry.

As recently as March 9, 2009, the USSC ruled to support arbitration clauses in contracts between lending institutions and its customers in the case, Vaden v. Discover Bank. Vaden v. Discover Bank, 07-773, 08 C.D.O.S. 2829, was decided 03-09-2009 in the Supreme Court of the United States on Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit opinion filed March 9, 2009. Justice Ginsburg delivered the opinion of the Court; she opined that "Section 4 of the Federal Arbitration Act, 9 U. S. C. §4, authorizes a United States district court to entertain a petition to compel arbitration if the court would have jurisdiction, "save for [the arbitration] agreement," over "a suit arising out of the controversy between the parties." Justice Ginsburg describes the typical facts giving rise to the case stating that... "The litigation giving rise to these questions began when Discover Bank's servicing affiliate filed a complaint in Maryland state court. Presenting a claim arising solely under state law, Discover sought to recover past-due charges from one of its credit cardholders, Betty Vaden. Vaden answered and counterclaimed, alleging that Discover's finance charges, interest, and late fees violated state law. Invoking an arbitration clause in its cardholder agreement with Vaden, Discover then filed a §4 [Federal

Arbitration Act] petition in the United States District Court for the District of Maryland to compel arbitration of Vaden's counterclaims. The District Court had subject-matter jurisdiction over its petition, Discover maintained, because Vaden's state-law counterclaims were completely pre empted by federal banking law. The District Court agreed and ordered arbitration. Reasoning that a federal court has jurisdiction over a §4 [Federal Arbitration Act] petition if the parties' underlying dispute presents a federal question, the Fourth Circuit eventually affirmed."

Summarizing the Vaden decision, the majority of the USSC reversed the 4th Circuit lower court decision and reiterated the power of the arbitration clause by concluding that state courts as well as federal courts are obligated to honor and enforce agreements to arbitrate. Finally, FAA§2 is binding on state courts and this requires an interpretation of arbitration clauses which favors arbitration; the exact language of the relevant federal statute section states that FAA§2 renders agreements to arbitrate "valid, irrevocable, and enforceable."

The insight gleaned from this latest decision on arbitration clauses should enhance knowledge based decision making and suggests that businesses of any size, in any industry can likewise employ arbitration clauses to avoid litigation and reap the benefits, noted above, of arbitration.

Bankruptcy

Bankruptcy data available for every jurisdiction from the American Bankruptcy Institute (www.abi.org) demonstrates that the bankruptcy rule changes of 2005, in concert with the downturn in the economy, have meshed to create a statistical upsurge in the filings of chapters 7, 11 and 13 bankruptcies. Some fail to see bankruptcy as a strategic business maneuver and it is a sad fact that business owners often fail to recognize the key warning signs of vendor, supplier, client or customer impending bankruptcy.Since bankruptcy is an exclusively federal subject matter, though individual state rules can apply where permitted, it remains dangerous and short sighted to ignore the warning signs of bankruptcy.

Bankruptcy warning signs include the creation of Receivership status; approximately 80% of businesses in receivership eventually will enter Bankruptcy and the constraints upon creditors who join a bankruptcy proceeding are far more onerous than in the pre-bankruptcy stages. Receivership is a red flag that bankruptcy is imminent.

Other key warning signs that bankruptcy will occur include late pays, reduced pays, or excuses for pays by accounts payable customers. The legal insight objective to keep in focus is to recognize that any disturbed pattern of payment signifies financial stress and financial stress is a precursor to bankruptcy.

Finally, requests to re-negotiate classic terms of longstanding contracts and any reduction in business related communications, known as the ostrich syndrome, also signify financial stress that typically precedes bankruptcy.

Two interesting cases tangentially touching on bankruptcy reached the USSC and the lessons in each case provide significant legal insight decision making opportunity. In the United States v.

Galletti case, a partnership declared bankruptcy, and as we know, back taxes owed to the IRS cannot be discharged in bankruptcy. In the Galletti case, a former partner of the now dissolved partnership argues that he (Galletti) was not responsible for the back taxes assessed by the IRS upon a former partner for a now defunct partnership. In this case, the USSC confirmed that the Statute of Limitations for the IRS to assess a tax is 3 years from the time the tax return is filed, or should have been filed. However, provided the IRS makes the tax assessment within the 3 year limit, then the time permitted to collect the tax debt is 10 years from the date of assessment. Galletti answered a very important legal question about tax liability for defunct partnership: If a "Partnership" is the assessed taxpayer, are the individual partners liable up to 10 years later?

The resounding answer to this question is yes. If the IRS timely assesses the partnership "taxpayer" within 3 years, then the law of Partnership which makes each and all individual partners jointly and severally liable, extends the debt collection period for up to 10 years after the IRS assessment of taxes due; and each individual former partner, even though not personally assessed nor personally notified of the IRS tax assessment, is subject to collections actions for up to ten years until the debt and interest and fines is fully satisfied. Note that the collection power of the IRS ranges from garnishment and attachment to confiscation and the IRS is a supreme debt collector. Obvious lessons from this case include the need to reconcile financial obligations and terminate business entities completely, including all prospective tax obligations. Certainly, the form of business of partnership is less desirable than is any other form of business entity due to the feature of joint and several liability unique to a partnership.

Contractors and Status as Independent Contractors or Employees

There has always been a tense relationship between the IRS view on employee status versus independent contractor status and the benefits of the Independent contractor status to the employer. For example, employers are not liable for torts committed by independent contractors, nor are employers responsible for payment of withholding taxes for independent contractors. These two benefits alone created an inducement for the world's largest private ground carrier, Roadway [now FedEx Ground] to declare in California that its drivers were to be classified as independent contractors rather than employees. However, this brilliant bit of business strategy has backfired on FedEx in a rather terrific legal manner.

In a landmark California case, Estrada v. FedEx Ground, the employer FedEx has found that drivers' status as an independent contractors cannot be guaranteed even if so declared under written contract. Current IRS tax laws recognize there are numerous factors which guide but may not absolutely determine the proper classification as either employee or as independent contractor. The FedEx case demonstrates that employers must use 10 classic factors to determine true independent contractor status or they might well rue the consequences. These are 10 classic factors to consider: close supervision, uniforms, training, tools, full time, hours of work, peripheral work, payment, expenses, statutory class. In California, a state statute clearly requires proper classification of

workers as either employees or independent contractors and the intentional misclassification of workers constitutes fraud and is criminal under the statute California Labor code §2802.

In the landmark case, Estrada v. FedEx Ground filed in Los Angeles Co. Superior Ct. decided on December 19, 2005. Two later appeals modified the ground breaking class action decision against FedEx for misclassifying all single route drivers as independent contractors rather than employees; but left the liability issue intact. FedEx's action was determined by the court to be in violation of California law. This class action lawsuit of about 200 class members in California included an injunction against FedEx to halt the practice and awarded $5.3 million to plaintiffs. Note: $12.3 million awarded for attorney fees.

The consequences of this lawsuit, a dispute resolved via litigation, not arbitration will be tremendous. The details of the dispute have spawned more litigation in other jurisdictions; there are more than 32 suits from 25 states which may or may not be consolidated asking for wage and hour compensation and reimbursement for fuel, oil, tires, repairs and liability insurance; these lawsuits also challenge the practice of firing employees and then re-hiring these workers as independent contractors to avoid paying taxes, benefits, insurance and other employee related expenses and entitlements.

The ripple effects of this lawsuit are enormous. The consequences of using a strategy to circumvent financial costs associated with hiring, training and retaining employees will include an industry wide examination of all carriers who classify drivers as independent contractors; then there will likely be an expansion to other industries who have utilized this independent contractor strategy. For the record, other jurisdictions, including Massachusetts and Indiana have followed the California Estrada v. FedEx court decision and challenged the classification of drivers as independent contractors.

However if the reason for the strategy in the first place was to save costs, then the outcome is essentially one of ironic proportions. The reason this cost-saving strategy has monumentally backfired is that the IRS has already reached back three years from the Estrada decision of 2005 in California and levied over $319 million in fines and penalties against FedEx for failure to pay withholding taxes to the drivers it intentionally misclassified, starting with the tax year 2002; of course, the IRS will utilize its power to assess back taxes for each subsequent year and employ its power to collect those taxes for the full ten year collection period for each assessment period.

Contracts and Designer Contracts

All business contracts one writes are potential allies, but all contracts written by the other party are potential enemies. The legal insight decision making model would emphasize that use of "Boilerplate" contracts, those in which standard terms are inserted without regard to custom requirements of the parties typically benefit the author not the other party to the contract. Therefore, businesses which employ contracts to define relationships and terms and conditions should customize those contracts and use written contracts to clearly state policies that will protect the

interest of the contract writers and notify others of specific practices, including arbitration, collection practices, liquidated damages and related custom issues.

Contracts should be used to define deadlines and to state consequences and expectations on the face of the contract; thus requirements for parol evidence will be moot.

Embezzlement and Fraud

Query: What percentage of small businesses may be likely to experience an incidence of embezzlement during the lifetime of the business? Response: 100%

All embezzlers share the same characteristics: they are intelligent and trusted employees placed in a position of control with little or no oversight due to their very loyal personality.

Fraud is a complex and multifaceted illegal behavior; creative accounting, escrow fund abuses, tax evasion, billing "errors", valuation and insurance frauds are examples; but the list is endless and both civil and criminal sanctions are available to remedy fraud. Criminal fraud is more likely to be prosecuted than ever before due in part to private attorney general statutes including those created by Sarbanes-Oxley, according to official court statistics (usdoj.gov; www.uscourts.gov; www.soxact.org).

The increase in fraud prosecutions is related to multiple factors including perceived public demand and support to prosecute, convict and punish. Some reasons fraud investigations and enforcement are favored by prosecutors include mandates of Federal sentencing to uniformly impose stiffer penalties; higher standards of personal liability and responsibility by owners, directors and firm fiduciaries; the fact that fraud defeats the corporate shield laws; and unfortunately, the fact that media darlings are created [prosecutors] and destroyed [defendants].

Stoneridge Investment Partners v. Scientific-Atlanta Inc. decided January 2008 by a 5-3 majority provides a current example of extension of fraud liability. In this case, Chief Justice John Roberts first recused himself, but then sold his stock in an involved firm and rejoined the justices to fully participate in the deliberations. The USSC ruled that 3rd parties were not liable under the SEC for investor losses due to 2nd party fraud even if those 3rd parties actually knew of the fraud. The reasoning for this outcome is entirely based upon a strict reading of the SEC provision rule under question. In the question at hand, a class action suit, in which the class was seeking redress and damages under SEC rule 10(b) from 3rd party deep pockets, the class must prove that a legal cause of action exists under SEC rule 10(b) justifying vicarious liability for actions not recognized under the SEC 10(b) rule. To date, the 10(b) rule has not been so extended.

CONCLUSIONS AND IMPLICATIONS

No business enterprise can exist successfully without a legal plan to direct, design and even deter the principals from dangerous practices. This is true whether in start up, growth or maturity phase. A comprehensive Legal Audit© is a useful tool and can significantly affect business

performance fault lines and how to predict where the quakes will occur using the Legal Audit © tool. Knowledge of the key USSC decisions extracting lessons from these decisions and applying this knowledge to gauge the effect upon business issues is essential in the legal insight decision making model.

Track notable decisions regularly. Usually August is prime season to identify hot topic cases and many Certiorari grants are determined over summer and finalized for October; the writs are based upon discord, dissent and politics and thus these elements will affect business practices. Key cases arise from forum differentials in high octane forums such as the 4th and 9th circuits and a modicum of uniformity is desired by USSC. Therefore discord among the circuits on the same or similar issues is a good predictor of certiorari.

Knowledge of the matters at issue relating to business should be an on-going obligation of good strategy and good planning. Managers and owners should react by adjusting business practices to comply with judicial outcomes and adjust current practices by using simple contractual language to define desired outcomes.

Whether the business is in start-up phase, growth phase or is fully developed, all businesses and owners should use a standardized approach to check the legal soundness of their company. A simple, but comprehensive Legal Issues Audit©" will be a cost effective and efficient method to identify problem areas and prepare for corrective action.

Leading cases are potent red flags to signal that legal insight decision making strategy should be instituted and implemented to enhance business performance.

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WAYS MANAGERS INTERPRET AND ACT ON COMMON WORKPLACE EVENTS: IMPLICATIONS FOR THE ENTREPRENEURIAL EXECUTIVE

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ABSTRACT

Entrepreneurial executives actively seek opportunities for their companies. Their efforts to identify these opportunities and commercially exploit them can be greatly enhanced by subordinates that constructively collaborate with their coworkers to actively seek information that leads to opportunity recognition and exploitation. This study assesses the effect of the Need for Closure (NFC) on the degree credit union managers rely on their own experiences and coworkers of equal hierarchical rank in interpreting common workplace events. The patterns of behavior they exhibited in interpreting and acting on these events should also be reflective of how these individuals would pursue entrepreneurial activities. Respondents were classified into two equal size groups based on their NFC (Webster & Kruglanski, 1994; Kruglanski, Webster & Klem, 1993) scale scores. The high and low NFC group's scores on the Event Management Questionnaire (Smith, Peterson & Schwartz, 2002) were then compared as to the effect their own experiences and coworkers of equal hierarchical rank had on managing workplace events. The results supported the hypothesis that NFC would be negatively related to the reliance on coworkers, but did not support the hypothesis that NFC would be positively related to reliance on the managers' prior experience. Post Hoc analysis revealed that the relationship between NFC and reliance on coworkers was only significant in the case of female respondents.

INTRODUCTION

Performing the role of manager involves indentifying issues that require the attention of the manager, seeking guidance when necessary on how best to resolve the issues, making a decision as to what alternative course of action to take and implementing that decision. Some situations that are interpreted by a manager as routine, or of minor consequence, are resolved by decisions that are made quickly and often intuitively with little information search or analytic activity. Other situations are interpreted as more complex, novel or important and, therefore, require significant information search and analysis before action can be taken by the manager (Smith, Peterson, & Schwartz, 2002).

An individual's need for closure (Webster & Kruglanski, 1994) may influence the interpretive and decision-making process by affecting the amount and type of guidance that is sought. A manager

that has a higher need to reach a state of cognitive closure would be less likely to tolerate a longer period of ambiguity in resolving situations. As a result, the expectation would be an individual that has a high need for cognitive closure would be significantly less likely to seek guidance from a number of sources in analyzing situations than an individual with a lower need for closure. Individuals that utilize fewer sources of guidance are more likely to be intuitive decision-makers and, as a result, be more likely to make an incorrect decision than an individual who has followed a logic-based process involving appropriate information search and analysis. Achieving a greater understanding of how individual differences affect decision-making processes potentially helps improve those processes.

This study investigates how a manager's need for closure affects the manner in which the manager seeks guidance from his or her peers and relies on personal experience when dealing with work-related situations that are both commonly encountered and relatively important. Because this study is a field study of actual managers performing common managerial activities, it has the potential of providing valuable insights into managerial decision-making behavior. This understanding is important in a wide range of decision-making situations, including those in an entrepreneurial context. Individuals that are more collaborative in the workplace and less likely to make quick, intuitive decisions potentially represent a much more valuable resource to the entrepreneurial executive seeking to identify and exploit market opportunities than individuals that are less collaborative or that tend to reach cognitive closure more readily. Similarly, possessing an understanding of the entrepreneurial benefits of collaborative behavior and the threats to entrepreneurial activity posed by an individual's tendencies to seek premature closure should provide motivation for the entrepreneurial executive to engage in sufficient information seeking and analytic behavior prior to making important decisions related to opportunity exploitation.

Event Management

The criterion variable in this study is the extent various information sources are utilized to interpret and sometimes act upon complex events commonly encountered by managers in the workplace (Peterson & Smith, 2000). Prior research (Smith, Peterson & Schwartz, 2002) has identified the individual, organizational and cultural sources of guidance commonly accessed in dealing with these situations. At the individual level, expertise is developed through experience and training. At the organizational level, persons providing guidance include superiors, subordinates specialists and coworkers. Impersonal sources at the organizational level include formal rules or informal organizational norms. In addition, beliefs that are grounded in aspects of culture such as ideology or religion provide additional interpretive guidance. The extent the sources including "my own experience" and "other people at my level" are assessed in the present study.

The effect of culture on which sources of guidance are used in event management has been a common focus of this research stream. For example, Smith, Peterson & Wang (1996) compared the sources of guidance British and Chinese managers used in interpreting managerial events. Their data

supported the finding that British managers relied heavily on their experience and training, while the Chinese managers relied more heavily on written rules and procedures. In a comparative study of work teams from Japan, Britain and the United States, Smith, Peterson and Misumi (1994) found evidence that the most frequently used source by Japanese teams in dealing with work events were coworkers, while in Britain and the United States team members relied on their own experience and prior training. These studies support the notion that cultural-level values, "… can predict substantial variance in use of some of the most widespread sources of guidance" (Smith, Peterson & Schwartz, 2002, p. 205).

Therefore, the utility of this methodology in assessing managerial information seeking behavior in the context of realistic workplace situations has been demonstrated in several published studies that focused on identifying how cultural affiliation results in differences in that behavior. This methodology should similarly be useful in assessing what effect individual differences in cognitive traits have on informational source usage. Information source usage is important in many aspects of entrepreneurial activity, such as opportunity recognition, where information asymmetry (Hayek, 1948) gained from collaborative activity provides a competitive advantage.

Need for Closure

The predictor variable in this study is need for closure (Kruglanski, 1989), a cognitive trait proposed to affect decision-making behavior. This type of closure is based on the notion that individuals differ in their need for "the desirability of any answer as long as it is definite" (Kruglanski & Webster, 1996, p. 263). The need for nonspecific closure is a latent variable reflecting the summed scores of the observed variables of discomfort with ambiguity, preference for order, preference for predictability, decisiveness, and close-mindedness (Kruglanski, 1989; 1990a; 1990b). Need for closure is proposed in the present study to be a likely determinant of guidance seeking behavior in a workplace context. An individual that has a relatively high level of the need for closure would presumably be less motivated to seek guidance about interpreting a workplace event if seeking guidance may lengthen the process to achieve closure.

This presumption is based on the notion that an individual with a high need for closure is more likely to rely on earlier clues to form a final judgment than a person with a low need for closure. This increased likelihood is due to both an urgency tendency, "the need to seize on closure quickly", and a permanency tendency, "the desire to perpetuate closure giving rise to the dual inclination (a) to preserve, or freeze on past knowledge and (b) to safeguard future knowledge" (Kruglanski and Webster, 1996, p. 265). Thus, the executive who has a high need for nonspecific closure may be less likely to undertake the effortful and time consuming information search and analytic activity required by System 2 reasoning and is more likely to use decision-making heuristics and be more prone to biases such as overweighting initial information in making an initial decision (Kahneman, 2003; Stanovich & West, 2002).

In the context of interpreting workplace events, certain hypotheses would likely be supported by the notion that the need for closure would affect how an executive seeks information related to that interpretation. Sources that require substantial time to access or are likely to provide conflicting or difficult to understand guidance would be expected to be underutilized by executives that have a high level of need for closure. Conversely, reliance on an executive's own experience would not be expected to involve these impediments to obtaining closure. Consequently, that source should be expected to be more heavily utilized by high need for closure executives. Based on these expectations, the following hypotheses were assessed in the present study:

Hypothesis 1: When interpreting events, executives with higher levels of need for closure will utilize coworkers as sources of guidance less than executives with lower levels of need for closure.

Hypothesis 2: When interpreting events, executives with higher levels of need for closure will utilize their own experience as a source of guidance more than executives with lower levels of need for closure.

METHOD

This study sampled participants in multiple sessions of a Credit Union executive training program. The attendees were asked to complete the written instrument in advance of attending the training sessions. Attendees that had not completed the instrument by the completion of the sessions were contacted and reminded to return the completed surveys. Participants that returned a completed survey were paid $5. A total of 143 instruments were provided to attendees and 109 usable surveys were returned. Therefore a 76% response rate was achieved using this protocol.

Demographic information relating to the respondents is displayed in Table 1. In summary, 61% of the respondents were female and 73% were between the ages of 26 and 46. Over 70% of the respondents had been with their employer greater than 7 years. The respondents were well educated with 67% having achieved a bachelors or masters degree.

MEASURES

The predictor variable in this study was measured using the Need for Closure Scale (Webster & Kruglanski, 1994; Kruglanski, Webster & Klem, 1993). This scale contains five subscales: preference for order, preference for predictability, decisiveness, discomfort with ambiguity and close-mindedness. This scale employs forty two items measured with a six point Likert-type scale with "strongly agree" and "strongly disagree" as anchor points. An example of one item of this scale is "I usually make important decisions quickly and confidently."

Table 1: Demographic Profile of Respondents	
Age	%
<25	12.1
26-30	25.2
31-35	17.8
36-40	10.3
41-45	19.6
46-50	7.5
51-55	4.7
>55	2.8
Total	100.0
Gender	%
Female	60.7
Male	39.3
Total	100.0
Age of Employer	%
0-15 years	10.0
>15 years	90.0
Total	100.0
Education Level	%
High School	20.6
Associate Degree	12.1
Bachelors Degree	57.0
Masters Degree	10.3
Total	100.0
Years with Employer	%
0-3 years	11.2
4-6 years	17.8
7-9 years	22.4
10-15 years	13.1
>15 years	29.9
Total	100.0

The Cronbach's alphas for Need for Closure Scale were .84 in the two samples used in the Kruglanski, Webster and Klem (1993) scale developmental study. The scale achieved a Cronbach's alpha of .78 in the present study. This level of reliability is considered acceptable, particularly for early stage research (Nunnally, 1978; Pedhazur & Schmelkin, 1991).

The criterion variable in this study was measured using a portion of the Event Management Questionnaire (Smith, Peterson & Schwartz, 2002). This questionnaire measures the extent that an executive's actions related to specific events are affected by the use of specific sources of guidance. The eight events in the scale are:

- When a vacancy arises that requires the appointment of a subordinate in your department.
- When one of your subordinates does consistently good work.
- When one of your subordinates does consistently poor work.
- When some of the equipment or machinery in your department seems to need replacement.
- When another department does not provide the resources or support you require.
- When there are differing opinions within your department.
- When you see the need to introduce new work procedures into your department.
- When the time comes to evaluate the success of new work procedures.

The extent to which the respondent's actions were affected by specific sources of guidance was measured with a five item Likert-type scale with "to a very small extent" and "to a very large extent" as anchor points. In the present study, the source of guidance that was assessed was coworkers described as "other people at my level."

The Cronbach's alpha for Event Management Questionnaire was .96 in the multinational Smith, Peterson & Schwartz (2002) study. The scale achieved a Cronbach's alpha of .88 in the present study. This level of reliability is considered satisfactory using the previously cited standards.

RESULTS

The descriptive statistics and correlations between measures are shown in Table 2. The measures used in this study were ordinal. Respondents were equally divided into high and low need for closure groups based on their need for closure scale scores. The nonparametric Mann-Whitney *U* test (Anderson, Sweeney & Williams, 1999) was then utilized to compare the mean values of the use of coworkers and use of experience criterion variables for the high and low groups of need for closure score respondents. This method was used to test the hypothesis that predicted a significantly higher use of coworkers as informational sources to help interpret common workplace events for executives with a low need for closure than for a high need for closure. In addition, this method was also used to test the hypothesis that high need for closure executives would rely on their own experiences to guide their interpretation of workplace events significantly more than low need for

closure executives. For comparative purposes, conventional *t* tests for the high and low need for closure groups with respect to the criterion variables were also performed. The results of the tests are shown in Table 3.

Table 2: Descriptive Statistics and Correlations

Variable	N	Mean	Standard Deviation	Need for Nonspecific Cognitive Closure	Coworkers as Source for Guidance	Experience as a Source for Guidance
Need for Nonspecific Cognitive Closure	99	3.86	.42	1.00		
Coworkers as a Source for Guidance	99	2.76	.98	.19^{+}	1.00	
Experience as a Source for Guidance	100	3.63	1.09	.05	.41**	1.00

$^{+}p<.10$ $^{*}p<.05$ $^{**}p<.01$ (2-tailed)

Table 3: Results of Tests of Hypotheses Related to High and Low Levels of Need For Closure and Related Effect of Respondent Gender

Criterion Variable	N	Mann Whitney U Test *Z*	Mann Whitney U Test *Significance*	T-Test *F*	T-Test *Significance*
H1-Use of Coworkers					
Female Respondents	54	2.38	.02	2.24	.03
H1-Use of Coworkers					
Male Respondents	37	.30	.77	.03	.97
H1-Use of Coworkers					
All Respondents	91	2.29	.02	2.21	.03
H2-Use of Experience					
Female Respondents	55	.84	.40	.66	.52
H2-Use of Experience					
Male Respondents	37	.55	.58	.76	.45
H2-Use of Experience					
All Respondents	92	.04	.97	.40	.69
(2-tailed)					

The comparison of the high and low need for closure groups with respect to the use of coworkers as interpretive sources for work events resulted in a significant difference in these Mann Whitney U Test values, z= 2.29, p=.02. As predicted by the hypothesis, the high need for closure group of managers utilized their coworkers as interpretive sources less than the low need for closure group. For comparative purposes, a *t* test was also performed also resulting in a similar significant difference in these mean values, z= 2.21, p=.03. A *post hoc* analysis of the effect of gender was performed to assess any effect gender would have on the extent to which the need for closure affected the use of informational sources. The results supported the presence of a gender effect on this relationship. The Mann Whitney U Test values between the high and low need for closure groups with respect to the use of coworkers as information sources were significant for females, z= 2.38, p=.02, but not for males, z= .30, p=.77.

The comparison of the high and low need for closure groups with respect to the use of the respondent's own experience as an interpretive source for work events did not result in a significant difference in these Mann Whitney U Test values, z= .04, p=.97. As a result, the hypothesis that the high need for closure group of managers utilized their experience as interpretive sources more than the low need for closure group was not supported. For comparative purposes, a *t* test was also performed also resulting in a similar significant difference in these mean values, z= .40, p=.69. Neither the high or low need for closure groups was significantly different with respect to the affect of their experience to interpret work events in this sample. A *post hoc* analysis of the effect of gender was also performed on this relationship. No significant gender effect was noted with respect to the affect of experience as neither gender reflected a significant relationship between need for closure and the use of experience in interpreting work events. Table 4 reports a summary of gender differences with respect to the mean values of the predictor and criterion variables.

Table 4: Gender Differences in Predictor and Criterion Variables

Variable	Female N	Male N	Female Mean	Male Mean	*t*	Significance (2-tailed)
Need for Nonspecific Cognitive Closure	59	40	3.93	3.76	1.95	.06
Coworkers as a Source for Guidance	60	39	2.80	2.69	.59	.56
Experience as a Source for Guidance	61	39	3.50	3.83	1.51	.13

DISCUSSION

The present study assessed the effect that a cognitive trait, need for nonspecific cognitive closure (Webster & Kruglanski, 1994; Kruglanski, Webster & Klem, 1993) has on how managers in actual business settings perceive and act upon important and commonly encountered work events. This trait is the result of many motivational factors. Some factors that would motivate an individual to reach closure include the desire for predictability, the desire to commence action, the desire to avoid laborious information search and analysis, the desire to avoid dull or repetitive activities (Webster & Kruglanski, 1994).

Managers periodically encounter novel situations, both inside and outside of the firm, that require decisions as to whether action is required in response and, if action is necessary, what alternative course of action is preferable. One widely held theory of decision-making behavior posits that decisions are the result of one of two distinct reasoning processes (Kahneman, 2003; Sloman 2002; Stanovich &West, 2000; Epstein, 1994). The experiential (Epstein, 1994) or System 1 (Kahneman, 2003; Stanovich & West, 2002) method of reasoning describes a method of reasoning that is fast, automatic, effortless and affected by emotion. In contrast, the rational (Epstein, 1994) or System 2 (Kahneman, 2003; Stanovich & West, 2002) method of reasoning operates in a slow, controlled, effortful manner. Kahneman (2003) describes interaction between the two systems as a continual operation of System 1 with continual, but often lax monitoring and occasional intervention of System 2 to correct or override a System 1 decision. Sloman (1996) characterizes the systems as having overlapping domains that vary as a function of the individual's knowledge, skill and experience. He describes each system working within a single individual as "…two experts who are working cooperatively to compute sensible answers" (p. 6).

When dealing with important situations, a manager using the System 2 method of reasoning would engage in a logic-based decision-making process that involves seeking all necessary information to interpret the situation, drawing inferences regarding that information using the basic rules of logic and probability theory, and acting on the inferences that result in a manner that maximizes the utility to the organization. Alternately, a manager using the System 1 method of reasoning would engage in decision-making after seeking much less information, would often employ heuristics, and would make decisions that would more likely be affected by emotions. The reasoning system the manager uses may determine the rigor of the information search, the effort put forth in the analysis of the information gathered and the accuracy of the inferences that result from that analysis.

The need for closure (Kruglanski, 1989; 1990a; 1990b) is proposed in the present study to be particularly predictive as to the degree individuals will undertake the effortful task of seeking guidance from a variety on informational sources in interpreting and acting upon important events. When compared to the individual with a lower need for nonspecific closure, Kruglanski and Webster (1996, p.278) propose that the individual who has a higher need for nonspecific closure would be more likely than an individual with a lower need for nonspecific closure "…to seize and then freeze

on early judgmental cues" often stemming from their prior work experience, rather than actively seeking guidance from other individuals. Therefore, considering the effects of need for closure, the expectation in the present study was that high need for closure executives would rely more on their experience in interpreting workplace events than low need for closure individuals, and low need for closure executives would rely more upon their coworkers for guidance than high need for closure executives.

The first finding was that there was no significant difference between low and high need for closure executives in the degree they relied upon their experience for guidance in interpreting and acting upon workplace events. Respondents reported their actions were more effected by opinions based on their prior experience (mean score 3.63) than by information gained by interacting with coworkers at the same hierarchical level (mean score 2.76). However, their scores relating to the effect of relying on their experience did not significantly differ when they were assigned to low and high need for closure groups. One possible explanation for the higher mean value reported for the effect experience had on influencing an executive's actions than for the score for the effect of equal rank coworkers is the relative lack of time and effort required by the manager to recall past experiences and apply them to current workplace events compared to time and effort involved with interacting with coworkers. This explanation is consistent with a the dual process of reasoning theory that predicts a greater use of the quicker and easier intuitive decision process compared to a slower and more effortful logic-based process. Unfortunately, many of the workplace events used in the present study would best be addressed by a logic-based decision process rather than quick, intuitive decision-making.

The second finding supported the hypothesis that low need for closure executive's decision-making process would be influenced more by coworkers than the high need for closure individual. However, the relationship between the degree of need for closure and the influence coworkers had in the decision-making process was not uniform between male and female respondents. Females respondents in this sample reported that their actions related to workplace events were more influenced by coworkers of equal rank than their male counterparts and, unlike male respondents, there was a significant difference between high and low need for closure groups. While scale developmental samples did not exhibit inherent differences between males and females in need for closure scores, these samples did not address whether the need for closure might affect the decision process in typical decision-making contexts. No prior studies were located that specifically investigated the extent that gender influences the degree need for closure affects ordinary decision making situations.

Some gender related findings have been noted in other studies that did relate to the effect of closure in other contexts. Sorrentino, Holmes Hanna and Sharp (1995) noted that certainty –oriented men were more likely than their female counterparts to tolerate negativity in personal relationships. They also noted that these differences were less pronounced between uncertainty oriented individuals of both genders. Kruglanski, Shah, Pierro and Mannetti (2002) discovered that, compared with low need for closure individuals, high need for closure individuals preferred

membership in more homogeneous groups, presumably because such membership in such groups facilitated reaching closure and posed less of a threat to that closure once it is reached. Thus, higher need for closure individuals may have more difficulty interacting with group members of the opposite gender than individuals with a lower need for closure. Fu, Morris, Lee, Chao, Chiu and Hong (2007) found two gender differences related to the Need for Closure. As an individual's Need for Closure increased, only females were more likely to assign importance to relational information about participants in a hypothetical conflict or use an accommodating style of managing conflict as measured by the Rahim (1983) scale.

Certain limitations of this exploratory study should be noted. The data was derived from a single instrument. Such methodology raises that possibility that common method variance may be present. To preclude the presence of any industry effects, the respondents were all participants in the same industry. However, sampling the participants from a single industry potentially reduces the ability to infer relationships to the population of managers in a variety of industries. While both the instruments for the predictor and criterion variables are widely recognized, we were unable to locate other confirmatory studies where these instruments had been applied in a similar context.

As this gender difference was discovered through a *post hoc* analysis, other aspects of how gender differences affect need for closure in a decision-making context that were not part of this study await further research. These include gender differences in same sex and opposite sex communication patterns between coworkers of the same hierarchical level when interpreting and acting on important workplace events. Examples of criterion variables related to these communication patterns that await further study with respect to gender and need for nonspecific cognitive closure predictor variables include the number of persons contacted, frequency of contact with individual sources, duration of contacts, type of information sought during the contact.

The insights gained from this study highlight the need for an entrepreneurial executive to create an organizational culture that minimizes potential negative effects caused by lower level managers failing to seek adequate collaboration in interpreting and acting upon both workplace events and market opportunities. Encouraging a culture that facilitates ongoing communication between all levels of the organizational hierarchy will increase the likelihood that, when faced with ambiguous, important decisions or uncertain market opportunities, collaboration will be increased. Because of the potentially harmful effects a high level of need for closure may have on a manager's decision-making ability, a personnel evaluation system that uses valid methodology to identify individuals abnormally prone to be the influences of this trait would be a useful tool in providing additional decision-making training for those individuals already employed, and in identifying individuals being recruited that may be ill suited for positions that require high degrees of logic-based reasoning, particularly in a group setting.

Similarly, entrepreneurial executives might want to consider developing more systematic approaches to their selection processes, orientation procedures, training and coaching efforts. For example, a structured approach to interviewing using questions specifically designed to seek interviewee responses to their information seeking and analytic behavior when encountering various

hypothetical events that are important and likely to be encountered in the workplace might give the executive better insight into the interviewee's problem solving approaches.

Orientation and training efforts could be designed to encourage collaborative behavior. These efforts could include assigning small group projects involving environmental scanning, identifying key success factors and assessment of projected internal strengths and weaknesses. This group activity would be expected to result in a sharing of analytic techniques and an increased tendency to employ more logic-based and less intuitive decision-making approaches. Coaching efforts by entrepreneurially oriented mentors would likely convey industry specific knowledge including insights into areas of the market where opportunities might be expected to be greater and alternative approaches to commercially viable ways to exploit those opportunities.

The entrepreneurial executive could also institute incentives and procedures that could encourage collaboration and encourages opportunity recognition and exploitation within the organization. Positive recognition of organizational members that engage in collaborative behavior and who have a history of proactively seeking opportunities for the organization should result in those behaviors and overcome tendencies some individuals may have to reach premature closure.

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S-CORPORATIONS AND FEDERAL EMPLOYMENT TAXES: SAFE HARBORS AND SUNKEN SHIPS

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ABSTRACT

This article provides answers together with legal precedence to a number of frequently encountered questions with respect to the taxation of S-Corporations and their shareholders. In addition, the article explains via court precedence the legal distinctions between an employee who pays FICA taxes, a shareholder of an S-Corp who receives a distribution and who is not an employee of the company, and a shareholder who is both a shareholder and an employee of the S-Corporation, as well as how and why an S-Corp must always have at least one employee who must pay FICA taxes (based on a salary typical of what others are paid who perform similar services). The article also examines two popular "games" many clients frequently want to play with respect to taxation applicable to S-Corporations and their shareholders.

INTRODUCTION

The following questions (and their supporting legal precedence) are frequently raised with respect to taxation applicable to S-Corporations and their shareholders**:**

- Is the sole shareholder of an S-Corporation subject to federal self-employment tax if the person characterizes the income as an S-Corp distribution (that generally is not subject to employment taxation)?

- Does an S-Corporation have to have at least one "employee" for employment tax purposes?

- How do tax practitioners explain to their clients (who own an S-Corp) the application of two seemingly contradictory rules, with one rule being that employers must pay and withhold employment taxes and a different rule being that

distributions from S-Corporations to its shareholders are not subject to federal employment taxation?

- What are some common but improper methods that tax practitioners need to be aware of that some clients may desire to implement in an effort to avoid paying federal employment taxes?

- Are there any safe harbor provisions available to help innocent taxpayers who mistakenly misclassify their employment status with regard to S-Corporations and federal employment taxes?

- What is the distinction in treatment between an employee who pays FICA taxes, a shareholder of an S-Corp who receives a distribution and who is not an employee of the company, and a shareholder who is both a shareholder and an employee of the S-Corporation?

- What are some potential problems with using S-Corporations from a federal estate tax perspective?

This article addresses the preceding questions and provides legal precedence that supports and explains the answers to such questions.

BACKGROUND AND PRECEDENCE

The Third Circuit Court of Appeals has decided a pivotal case concerning whether someone who is an officer and sole shareholder of an S-Corporation was an "employee," thereby subjecting the corporation to the requirement to pay federal employment taxes. The court's decision was one upholding an earlier decision by the Tax Court in the government's favor. In *Nu-Look Design, Inc. v. Commissioner of Internal Revenue,* 356 F.3d 290 (CA-3, 2004), the taxpayer (Nu-Look), which was an S-Corporation, petitioned for review of the IRS's determination that Ronald A. Stark, its officer and sole shareholder, was an employee of the company and that the company owed employment taxes. The Tax Court held in favor of the IRS, and Nu-Look appealed to the Third Circuit, which upheld the decision in favor of the IRS, holding that Mr. Stark was in fact an employee and that the S-Corporation owed employment taxes on distributions made to the S-Corporation's sole shareholder.

Nu-Look had operated as an S-Corporation since 1987, providing residential home-improvement services including carpentry, siding installation, and general home-improvement construction services to the general public. Mr. Stark was the sole shareholder and president. He also managed the company, solicited new business, performed necessary bookkeeping, handled

company finances, and hired and supervised workers. Mr. Stark did not take any salary for his services to the company, but rather he had the company make shareholder distributions to him when he needed the money. The company reported income on its Form 1120S (for years 1996, 1997, and 1998), and Mr. Stark reported the same amounts of income as non-passive income on Form 1040, Schedule E, for the same time period.

Nu-Look asserted that Mr. Stark was not an employee under FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act) laws, either as a statutory employee or as a common-law employee. Nu-Look contended further that even if it was mistaken as to Mr. Stark's employee classification, it should be entitled to relief under the safe harbor provisions of I.R.C. § 530 in that Nu-Look had a reasonable (even if mistaken) basis for not treating Mr. Stark as an employee. Nu-Look also made an argument that for procedural reasons it was denied due process by the IRS (which both courts rejected; see *Nu-Look* 356 F.3d at 295).

The court first addressed the fact that it had proper jurisdiction over the controversy. Next, it addressed the issue of whether Mr. Stark was a statutory employee. The court stated that the Federal Insurance Contributions Act (FICA) considers corporate officers to be automatically classified as employees. The court acknowledged an exception to this automatic classification for an officer who performs only minor services and who is neither directly nor indirectly compensated, citing Treas. Reg. § 31.3121(d)-1(b). The court agreed with the previous holding of the Tax Court that, factually, Mr. Stark's services were much more than "minor," and therefore he was not entitled to fall under the exception provided by the Treasury Regulations. The court affirmed that Mr. Stark was an officer of the corporation in his capacity as president (a fact that was not disputed by Nu-Look or Mr. Stark). Nu-Look argued that Mr. Stark was not *both* an employee as an officer and an employee under common-law principles; therefore, Mr. Stark should not be considered an employee. Nu-Look's argument failed on two levels. First, the statute does not require that one must be both a common-law employee and an officer in order to be classified as an employee. Quite the opposite--a plain reading of the statute states, *inter alia*, that one is an employee if one is an officer ***or*** would be considered an employee under a common-law analysis. The court went on to hold that in this case, Mr. Stark would be considered an employee because he was an officer of the corporation, that he performed substantial (more than "minor") services to the corporation, and that his services were enough to be considered an employee under common-law principles as well. In an effort to defeat the common-law classification, Mr. Stark argued that as the sole shareholder of the company, he was in control and therefore Nu-Look was not in control over him. The court rejected this line of reasoning and reiterated that even if the Tax Court did not address this argument, it did not need to do so because as president of the company (and not entitled to the "minor services" exception), Mr. Stark was determined by the lower court to be an employee for federal employment tax purposes.

Lastly, Nu-Look appealed for relief under the safe harbor provisions of IRC § 530, stating that it had a reasonable basis to believe Mr. Stark was not an employee, citing *Texas Carbonate v. Phinney [IRS]* 307 F.2d 289, 291-93 (CA-5, 1962) as supporting precedent. (Nu-Look tried to argue judicial precedent via *Texas Carbonate*, which was held to actually support the government, not Nu-

Look.) The court was most kind in calling Nu-Look's reliance on *Texas Carbonate* merely "puzzling." Any reading of *Texas Carbonate* could only support the government's position and would only add long-standing judicial precedence to the IRS's position. Under either the analysis of *Texas Carbonate* or Treas. Regs. § 31.3121(d)-1(b) and § 31.3306(i)-1(e), Mr. Stark would be classified as an employee. The court stated the three safe harbors listed in I.R.C. § 530 as being a taxpayer's reliance upon (1) judicial precedent, (2) past IRS audit, or (3) long-standing industry practices. The court then found that Nu-Look was not entitled to relief under any of the three provisions. Interestingly, the court stated that it agreed with and found "instructive" a Ninth Circuit case that held that a person must be classified as an employee if the person who is an S-Corporation's sole shareholder is the "central worker for the taxpayer" or if the person is a "corporation's sole full-time worker . . ." [citing *Spicer Accounting* 918 F.2d at 94-95].

Nu-Look lost on all counts, and Mr. Stark was determined by the Third Circuit to be an employee for federal employment tax purposes, with Nu-Look and Mr. Stark owing their share of such taxes.

THE INTERVIEW

The following situation may seem familiar to many tax professionals. You are in your office when Karl Klient walks in and asks you to help him do his taxes. He tells you about how he has recently been able to quit his construction job and start his own home-building business, which is growing and doing well. He tells you that he incorporated using an S-Corporation because he wanted the protection from potential creditors, and he didn't want to pay double taxes at both the corporate level and the individual level.

You look at Karl and say, "I understand. It sounds like you're off to a good start. Let's look at your financial information." You finish looking at his documented information and then ask him where the receipts for the employment taxes are. Karl responds, "What do you mean, 'employment taxes'?" You explain that while the corporation's income is not subject to its own income tax, it is liable for its half of the employment taxes based on how much it pays its employees. Karl's countenance changes as his face turns red, and he begins to get frustrated. "Look! I *told* you that I work for myself now and don't answer to any boss! It's *my* corporation--I do the work and make the money. Nobody signs my paycheck! Besides, everyone knows that an S-Corp doesn't have to withhold employment taxes from the distributions it pays to its shareholders. I called the IRS and even looked it up on the internet just to be sure. S-Corp money 'flows through' to its shareholders. What tax school did you graduate from?"

You are now contemplating how to explain to Karl that he is partly correct in that the following two statements are true**:**

- S-Corporation income "flows through" to its shareholders and is not subject to income taxation at the corporate level.

- Distributions made by S-Corporations to shareholders are not subject to employment tax withholding.

You are also trying hard to think of a way to explain how not *all* of the money that is earned by an S-Corporation can be paid directly to its shareholders as a shareholder distribution, but that some of the money earned by the company needs to be paid to its employee(s) who provided the services necessary for the corporation to earn its revenue. In short, the following statement is *also* true:

- S-Corporations are *not* exempt from the federal employment tax-withholding requirement for its employees.

- You are now wishing that you could summon the interpersonal skills of a Dr. Phil or that your office had a back door handy for a rapid exit. You look at Karl, and the conversation goes something like this:

YOU: "Karl, you are absolutely right about the tax rules you just quoted. The only hitch is that there are a couple of other tax rules that we have to apply because the IRS applies them and the federal courts will too. While you are indeed your own boss, as the boss or 'employer,' you are also your own 'employee' when you are working building houses." At this point, you notice that Karl's 19-inch neck is not as red as it was earlier, but he is still not sure of your expertise in the area. "Karl, it's like this," you continue to explain, "when you worked for AJAX Construction Company, they withheld money from your paycheck. You probably saw it noted on your pay stub as 'FICA' or something similar, right?"

KARL: "Yeah, that's right."

YOU: "So, the owner of AJAX could be lying around his swimming pool all day if he wanted to because he hired a management team to run the company and other employees to perform the construction work, right?"

KARL: "Sure, I suppose. As a matter of fact, I rarely ever saw the owner. We called him 'Mr. Bermuda' because he always seemed to be playing golf there."

YOU: "Assuming AJAX was an S-Corp, when AJAX made some money, it had to pay its suppliers and employees, and it also had to pay the employment taxes. AJAX paid half of the employment taxes itself and withheld the other half from your paycheck. Those were the social security and Medicare taxes--or FICA--as noted on your pay stub. You

may not have realized it, but they also paid federal unemployment taxes (FUTA); however, none of these taxes were withheld from your check, as your employer was required to pay them and not withhold these taxes from the employees' paychecks. Once all of the expenses of operating the business (and taxes) were paid, the company then would make a distribution of money to its shareholder(s), and no withholding was taken from this shareholder payment. Mr. Bermuda, as you called him, as a shareholder would get his share of corporate profits, and then he would report the income on his individual income tax return. Karl, your S-Corporation is just as real to the IRS as AJAX is. It is just a smaller-size S-Corporation."

KARL: "So how much money do I earn as an 'employee,' and how much do I make as a shareholder, like Mr. Bermuda? Oh, and my wife helps me by working ten hours a week answering the phone and doing office stuff. My son, Sam, is a surgeon, and he helped me get started in the business by contributing $100,000 so I could get a truck and some tools and take out an ad in the telephone book. My daughter, Donna, has actually followed in her old man's footsteps, as she has had her own window-installation contracting business for the last five years. When I build a new home for a customer, it's great to be able to hire my daughter to do all of the window-installation work. We are all shareholders in the S-Corp. Business is going great, the money is coming in, and I already have enough headaches dealing with sub-contractors--except Donna--and I don't want any more headaches, especially one with the IRS! So how do we get the S-Corp's taxes done properly, taking all the tax rules into consideration--and making sure that I, er, I mean, the corporation and I both do not pay too much in taxes?"

Thus, the interview continues with Karl, and you are no longer wanting or needing that handy back door in your office.

TAXATION BACKGROUND

It is important to understand and distinguish between the various applicable taxation schemes of which more than one can apply to any one person and/or entity. Specifically, tax professionals must be concerned with federal *income tax* as applied to employees, self-employed persons, shareholders of corporations, and the business entities themselves and must also be aware of the federal *employment tax* schemes and the requirements when employers are required to withhold such taxes from employee wages.

DISTRIBUTIONS TO SHAREHOLDERS OF S-CORPORATIONS

While S-Corporations and partnerships are similar in that they are both pass-through entities with regard to federal *income* tax, they are not treated the same for federal *employment* tax purposes. Partnership distributions are subject to *self-employment* income taxes [see Treas. Reg. § 1.1402(a)-1(a)(2)], while distributions to shareholders of S-Corporations are not subject to self-employment tax, as dividends paid to a shareholder are not considered "net earnings from self-employment" and, therefore, are not subject to section 1401 self-employment tax [see Rev. Rul. 59-221, 1959-1 CB 225 and *Ding v. Comr.,* T.C. memo 1997-435, *aff'd*, 200 F.3d 587 (CA-9, 1999)]. The IRS in its Publication 533 specifically states that while the income received via an S-Corp is includible in a taxpayer's gross income, it is not characterized as self-employment income [see also I.R.C. § 1366(a)-(b)].

So, if a person working for an S-Corp receives wages, the employee does not need to report and pay self-employment taxes. It stands to reason that if a person is not a self-employed person (e.g., an independent contractor), then the worker is an employee of the S-Corp, and, as such, the corporation must pay its share of employment taxes and withhold from the employee the worker's half of the employment taxes. This line of reasoning is precisely that taken by the IRS and the federal courts. The next section of this article considers employment taxes and their impact on employers, especially S-Corporations.

FEDERAL EMPLOYMENT TAXES

Employment taxes include the following (for more details, see Pub. 15 Circular E, Employer's Tax Guide)**:**

Social Security and Medicare Taxes. The Federal Insurance Contributions Act (FICA) provides for a federal system of old-age, survivors, disability, and hospital insurance. The old-age, survivors, and disability insurance part is financed by the social security tax. The hospital insurance part is financed by the Medicare tax, with each of these taxes being reported separately. The total rate of tax for 2008 is 12.4% for social security and 2.9% for the Medicare tax, with the employer paying one-half of the amounts and one-half of the amounts being withheld by the employer from the employee's paycheck (i.e., the employer pays 6.2% of the social security tax and the employee pays 6.2% via withholding, plus 1.45% each for the Medicare tax). For 2008, the first $102,000 of wages is subject to social security taxes. Wages paid in excess of this amount ($102,000 in 2008) are not subject to social security taxes. All of the employee's wages are subject without limit to the Medicare tax (for more information, see IRS Publication 15 Circular E, Employer's Tax Guide).

Federal Income Tax. An employer must withhold income taxes from wages paid to employees. A Form W-4 should be used and signed by each employee to determine the employee's amount

of tax withholding (see also the IRS website at www.irs.gov/individuals for assistance in calculating withholding).

Federal Unemployment (FUTA) Tax. The Federal Unemployment Tax Act (FUTA), together with state unemployment systems, provides for unemployment compensation benefit payments to workers who have lost their jobs. Employers usually pay unemployment taxes to both federal and state governments (see Pub. 926 for a list of state unemployment agencies). Only the employer pays FUTA tax. No FUTA tax is to be withheld from the employee's wages. If one spouse employs another spouse in a trade or business (not including domestic services), then the employee-spouse is normally not subject to FUTA tax (i.e., the employer-spouse will not owe FUTA tax on his/her employee-spouse's wages). However, the other employment taxes do apply. If one spouse employs his/her spouse but the employment is not considered a trade or business (e.g., domestic service), then such domestic service in a private home is not subject to social security, Medicare, and FUTA taxes. However, the wages of a child or a spouse are subject to income tax withholding as well as social security, Medicare, and FUTA taxes *if* such a_child or a spouse works for a corporation (or a partnership or an estate), even if the corporation is controlled by the child's parent or the individual's spouse. S-Corporations are just that--corporations. Federal unemployment tax should be reported on Form 990 (or Form 990-EZ, if applicable). FUTA taxes (as well as other employment taxes) are now generally paid via the Electronic Federal Tax Payment System (EFTPS). For more information on EFTPS, go to www.eftps.gov. Any new business that has federal tax obligations and that requests an employer identification number (EIN) will automatically be enrolled in EFTPS. Employers can opt to use EFTPS even if they are not required to use the system; otherwise, the employer may continue using the old coupon system and send payments and coupons to a federally authorized bank.

The employer (e.g., an S-Corporation) will report income and taxes withheld to the IRS and the worker via one of the following forms:

Form W-2 Wage and Tax Statement is used to report wages, tips, and other compensation paid to employees and to report any taxes withheld as well as any advance earned income payments.

Form 1099-MISC is used to report certain payments a business makes including payments of $600 or more for services performed for the business by non-employees, such as independent contractors, attorneys, accountants, or directors. Also, this form is used to report rent payments of $600 or more (other than rents paid to real estate agents) and royalty payments of $10 or more. The form is used to report winnings of $600 or more that are not for services (e.g., if a taxpayer wins a trip to Hawaii from a local radio station, the taxpayer will receive a Form 1099-MISC indicating the value of the prize--and this value amount will be treated as income to the taxpayer).

Form 8300 is used if a person receives a cash (or like) payment of over $10,000 (for more information, see IRS Pub. 1544 Reporting Cash Payments of Over $10,000).

Thus, while an S-Corp making a payment of a distributive share of corporate income to its shareholders is not considered a payor for purposes of employee backup withholding under section 3406, the corporation is still an employer and generally required to pay (and withhold when required) federal employment taxes. If the S-Corp has one or one thousand employees, it must pay/withhold federal employment taxes. There have been several cases citing *Nu-Look,* and all have held in accordance with the *Nu-Look* decision. The following cases discussing *Nu-Look* are listed in order of depth of discussion (from most to least): *Specialty Transport & Delivery Services, Inc. v. C.I.R.,* 93 AFTR 2d 2004-1364 (CA-3, 2004); *Veterinary Surgical Consultants, P.C. v. C.I.R.,* 93 AFTR 2d 2004-1273 (CA-3, 2004); *Grey v. C.I.R.,* 93 AFTR 2d 2004-1626 (CA-3, 2004); *Superior Proside, Inc. v. C.I.R.,* 93 AFTR 2d 2004-647 (CA-3, 2004); *Greco v. United States,* 380 F.Supp. 2d 598, 614 (M.D. Pa., 2005); *Peno Trucking, Inc. v. C.I.R.,* 93 T.C.M. 1027 (U.S. Tax Ct., Mar. 21, 2007). There has been one IRS Chief Counsel Advice memorandum issued on the subject as well, which also (not surprisingly) supports the holding in *Nu-Look* (see IRS CCA 200542034 (Oct. 21, 2005)). It is safe to state that if the corporation is engaged in any business at all, it will have at least one employee. The corporation is expected to pay applicable federal employment taxes based upon compensation that is reasonable, considering the nature of the services being performed by its employee--which leads to a discussion of the games some people play.

GAMES PEOPLE PLAY

Game #1: *Characterizing all of the income as a shareholder distribution or declaring "I'm just an independent contractor" if the shareholder argument fails.*

This game sounds like the following scenario: "I do not like the rules about the requirement for the payment of federal employment taxes. I want to be the sole shareholder (or merely one of 100 or fewer shareholders) of an S-Corp and characterize all of the money flowing through the S-Corp to me as being paid to me as a shareholder (and I might forget to report the money as self-employment income too)." Of course, not every taxpayer is so indifferent to the law. Although many taxpayers do rely upon the rule of S-Corp distributions not being subject to employment taxes and income tax withholding as the only and absolute rule concerning such distributions, those employees who do characterize *all* of their receipts received via an S-Corp as a shareholder distribution are running a great risk of ending up like the taxpayer in *Nu-Look Design, Inc.,* 356 F.3d 290 (CA-3, 2004), which was an appeal from the Tax Court where the government prevailed. Recall that in that case an individual, Mr. Stark, operated a home-improvement company. He was the sole shareholder and president of his S-Corp named Nu-Look Design, Incorporated. Mr. Stark actively managed the company, solicited new business, performed necessary bookkeeping, and hired and

supervised workers. He did not take any salary or wages from the company, but he had the company distribute money to him as his needs arose. Mr. Stark reported all such distributions as non-passive income on Schedule E of his Form 1040 tax returns for a three-year period. The court held that he was in fact an "employee" of the S-Corporation and that the S-Corporation was liable for federal employment taxes that were not paid.

Both the FICA and the FUTA impose taxes upon employers based upon the wages the employers pay to individuals in their employ. "Wages" include all remuneration for employment [26 U.S.C. §§ 3121(a), 3306(b)]. "Employment" is any service of whatever nature, performed by an employee for the person employing him [see 26 U.S.C. §§ 3121(b), 3306(c)]. While Treas. Reg. § 31.3121(d)-1(b) provides that there is an exception to the general rule that an officer of a corporation is an "employee" for employment tax purposes, the exception applies only to an officer who "does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration[.]" Note that one can become an "employee" of a corporation for FICA and FUTA purposes by being:

(1) any officer of a corporation, or
(2) any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee [see 26 U.S.C. §§ 3121(b), 3306(c)].

The court stated that under the facts presented in the *Nu-Look Design, Inc.* case, Mr. Stark was an "employee" for FICA/FUTA purposes, as he was both an officer of the corporation (and not entitled to the "minimal services rendered" exception) AND would qualify as an "employee" using the common-law standard as articulated in prior case law. Anytime a corporation has a *sole shareholder* who provides labor for a corporation, the sole shareholder is treated as an employee for FICA/FUTA purposes [see *Joseph Radtke, S.C. v. United States,* 712 F.Supp. 143, 145 (E.D. Wis. 1989), *affirmed,* 895 F.2d 1196 (CA-7, 1990)].

In a similar and more recent case, an S-Corp was held liable for failure to pay employment taxes when a husband-wife team each owned a 50% share of the S-Corp and the husband provided accounting services as a CPA and worked in furtherance of the corporation's business interests. The CPA argued that he was a mere shareholder of the S-Corp and his income was properly reported as corporate distributions and, in the alternative, if the court declined to rule in favor of his first argument, that he was an *independent contractor* and not an employee of the S-Corp. The court agreed with the government that the CPA was an employee of the S-Corp and not an independent contractor [see *Spicer Accounting, Inc.,* 918 F.2d 90 (CA-9, 1990)].

Game #2: Receiving inadequate compensation but also receiving greatly increased dividends.

The shareholder cannot take inadequate compensation from the corporation to avoid paying employment taxes [see Rev. Rul. 74-44, 1974-1 CB 331]. If a client wants to take $100 as salary and $100,000 as a dividend, he needs to be reminded that unless he is prepared to explain to a federal judge that only $100 is approximately what others are typically paid who perform similar services that he has performed, he had best not try that approach.

SAFE HARBOR RELIEF FOR THE INNOCENTLY MISTAKEN

When a taxpayer is mistaken regarding worker classification (e.g., the taxpayer classifies a worker as an independent contractor instead of correctly classifying the worker as an employee), I.R.C. § 530 provides a safe harbor. If the taxpayer (e.g., an S-Corp) can show a reasonable basis for not classifying a worker properly, it may avoid liability for its failure to file employment tax returns pursuant to I.R.C. § 6651 and for its failure to deposit payroll taxes under I.R.C. § 6656. A reasonable basis for the incorrect classification may be established if the taxpayer can show that it was done in reliance on judicial precedent, published rulings, past IRS audit, and/or long-standing practice of a significant segment of the taxpayer's industry. While such "reasonable basis" is to be "construed liberally in favor of taxpayers" [see *General Investment Corp. v. United States*, 823 F.2d 337, 340 (CA-9, 1987)], one should be careful not to be inordinately aggressive, as courts, including the U.S. Supreme Court, are also quick to look at the realities and substance of the underlying economic transactions and not the mere form of the transactions [see *Frank Lyon Co. v. United States,* 435 U.S. 561, 573 (S.Ct. 1978)].

APPLICATION OF THE LAW TO S-CORP OPERATIONS IN KARL KLIENT'S SITUATION

So, we are back in the office with our friend, Karl Klient, and need to advise him about how his S-Corp should handle its employment tax and shareholder distribution issues. His situation is most easily viewed by looking at the flow of money as occurring in two stages. First, the corporation receives capital and must pay its employees and independent contractors (if any). Second, the corporation will distribute net profits (net of business expenses, wages paid to employees, taxes paid, etc.) to its shareholders in accordance with the number of shares held by its shareholders.

In looking at Karl's company, Karl's Kastles, Inc., an S-Corp, and how it should be advised concerning federal employment taxes, let's make some basic assumptions, the first of which is that the corporation has issued 100 shares to its shareholders as follows: 55 shares to Karl (Karl is president of the company); 30 shares to his wife, Wanda; 10 shares to his son, Sam; and 5 shares to his daughter, Donna. [Note: For purposes of counting the number of shareholders to qualify for S-

Corporation status--a husband, wife, and all other family members are counted as one (1) shareholder with respect to the 100 shares.] A presumed reasonable compensation amount paid to Karl for his expert construction skills and for his service as president of the company (acquiring new customers, managing the daily operations of the company, etc.) would be $120,000 annually. A presumed reasonable compensation that would be paid to an employee performing clerical work in an office would be $10 per hour; thus, wife Wanda should be paid $10 per hour for the ten hours per week she works answering the phone ($5,200 annually). Daughter Donna is paid $35,000 for installing windows (materials and labor). Son Sam is paid nothing as an employee, as he is busy performing surgery (but he will receive a distribution later because he is a shareholder).

After considering the previously cited cases, it is doubtful that anyone could assert a reasonable argument that Karl is not an employee of the corporation, as he is an officer of the corporation and is providing substantial services for the company. Accordingly, the first $102,000 of Karl's wages in 2008 are subject to social security taxes. The company pays 6.2% and withholds 6.2% from Karl's salary check. Wages paid in excess of $102,000 (in 2008) are not subject to social security taxes. All of the employee's wages are subject without limit to the Medicare tax. Therefore, 1.45% of $120,000 is paid by the company, and 1.45% of $120,000 is withheld from Karl's paycheck for the Medicare tax. The company issues a Form W-2 to Karl and to the government reflecting his wages and withholdings, for use by Karl in preparing his individual income tax return (or joint return with Wanda).

Wanda's status is somewhat more interesting. If she is listed as an officer of the corporation, then she would generally be held to be an employee, but remember the exception for officers who perform minimal services. On the other hand, under a common-law analysis, she could be held to be an employee--but there are not sufficient facts presented to make that determination thus far (i.e., how much control does the company, via its president, Karl, exercise over her performance of services; does the company supply her with the tools needed for her to perform her tasks, etc.). Assuming the company determined that Wanda is not an employee and the government successfully challenged this determination, the safe harbor provisions may protect the company in this instance, as there is judicial precedent that could be used to argue that the company had a reasonable basis to not consider Wanda an employee but to consider her as a mere shareholder performing minimal services. In *Davis, d/b/a Mile High Calcium, Inc. v. United States,* 74 AFTR 2d 94-5618 (D. Colo. 1994), the court supported the taxpayer's characterization of S-Corp distributions as dividends payable to an officer who performed minimal services when the shareholder was the wife in a husband-wife team who held all of the shares of the corporation and when the wife merely performed twelve hours per month of clerical work. Wanda may or may not be listed as an officer, but note that Wanda works 10 hours *per week* rather than 12 hours *per month* (as in *Davis*). The less contestable alternative is to pay employment taxes on Wanda's $5,200. Of course, if Karl is willing to gamble on paying a tax attorney to litigate the issue in an effort to save a few hundred dollars, it would be Karl's decision. [Aside: The CPA readers are shaking their heads "no," while some tax attorney readers are smiling and thinking about telling Karl to "Go for it, as we can argue …."] If

the corporation decided to consider Wanda a clerical employee, it would pay/withhold employment taxes and issue her a Form W-2 reflecting such tax withholdings. If the corporation did not classify Wanda as an employee in an ambiguous situation and did so in reliance upon professional advice, then the courts should find a "reasonable cause" for the employment classification determination and allow the taxpayer to benefit from the safe harbor provisions under the Supreme Court holding in *United States v. Boyle,* 469 U.S. 241 (S.Ct. 1985), *reversing* 710 F.2d 1251 (CA-7, 1983).

For Karl's daughter, Donna, the facts as presented earlier would strongly indicate that she is truly an independent contractor. She is given an order to install windows and will be paid a flat amount for the work to be performed, with little or no control over how she will perform the task. Therefore, the corporation will not pay or withhold any employment taxes from Donna's payments totaling $35,000. The corporation will issue a Form 1099-MISC to Donna reporting to Donna and the government the amount paid to Donna.

For Karl's son, Sam, no wages of any kind are payable, as he has provided no services to the company in the capacity of an employee or of an independent contractor.

After paying all of the above wages to its employees and to its one independent contractor, and after paying all other business expenses, the corporation will next make distributions to its shareholders. The net profits are paid to the corporate shareholders as follows**:**

Karl receives 55% of the net profits (55 shares held with 100 shares issued);
Wanda receives 30% of the net profits;
Sam receives 10% of the net profits; and
Donna receives 5% of the net profits.

There should be no withholding of federal employment taxes from these payments, as they represent proper payments to the S-Corp's shareholders.

Note that in our hypothetical, the S-Corp is profitable. In instances where the S-Corp incurs a loss, there is a temptation for owner-operators of an S-Corp to use the corporate losses to reduce the owner's self-employment income for self-employment tax purposes. A taxpayer cannot offset S-Corp losses against self-employment income in calculating the self-employment tax when the taxpayer is an officer who performs significant services to the corporation (see IRS Letter Ruling 9530005, April 26, 1995). Remember, the taxpayer needs to account for the income from the S-Corp that is earned as an employee and the income that is received as a mere shareholder separately.

EXPLORATION OF ONE COMMONLY OVERLOOKED ESTATE-PLANNING "LAND MINE" WHEN DEALING WITH S-CORPS

Many closely held businesses are formed as S-Corporations in order to provide the operators of the businesses with the benefits of protecting their personal assets from creditor attack as well as pass-through taxation treatment, much akin to partnerships, for the corporations' shareholders. In

order to qualify for S-Corp status, a corporation must meet the criteria as specified in I.R.C. § 1361(b)(1), and not be an "ineligible corporation" under I.R.C. § 1361(b)(2). The corporation must be a domestic corporation that is incorporated in the United States. The corporation must not have more than 100 shareholders. For purposes of counting the number of shareholders, a husband and wife (and their estates) are counted as one (1) shareholder pursuant to I.R.C. § 1361(c)(1). Recent changes to the law (2004 American Jobs Creation Act amending IRC § 1361) permit family members to be counted as one shareholder together with their parents (i.e., a grand total of one (1) shareholder reflecting the parents and children). The term "members of a family" means the common ancestor, any lineal descendant of the common ancestor (up to six generations), and any spouse or former spouse of either common ancestor or any such lineal descendant. Individuals (other than a married couple) who hold shares of stock as tenants in common or as joint tenants are considered separate shareholders in determining the number of shareholders [see Treas. Reg. § 1.1361-1(e)(2)]. All of the shareholders must be individuals and be either U.S. citizens or resident aliens. As with most rules, there are exceptions. Some exceptions to the "individual person shareholder" rule allow the following types of entities to own S-Corp shares (and therefore not disqualify the corporation's "S" status triggering "C" corporation status together with the tax bill for corporate income taxes that are associated with C-Corporations)**:**

1. a deceased shareholder's estate--[i.e., if a deceased shareholder has 200 heirs, only the one estate is counted as "the shareholder" and not the 200 heirs],
2. a bankrupt shareholder's estate,
3. a Qualified Subchapter S Trust (QSST)--[only the current income beneficiary is treated as a shareholder (not current beneficiaries and potential beneficiaries as with the ESBT)],
4. an Electing Small Business Trust (ESBT)--[but if there are 200 beneficiaries of the trust, all 200 are counted as shareholders and may disqualify the corporation's "S" status],
5. voting trusts--[a trust established to exercise the voting rights of S-Corp stock transferred to it will be allowed to hold the S-Corp stock, and each beneficiary of the trust is counted as a shareholder (and each beneficiary must be otherwise qualified to hold S-Corp shares); other requirements apply but are beyond the scope of this article], and
6. specified tax-exempt organizations.

The preceding six entities are considered "individuals" eligible to hold S-Corp stock.

Additionally, an S-Corp may not issue more than one class of stock; however, for purposes of this rule, shareholder voting rights are disregarded. Therefore, an S-Corp may issue both voting and non-voting stock [see Treas. Reg. § 1.1361-1(l)(1)]. But beware of clients who want to provide for certain shareholders to have special rights as to profits or liquidation rights, as these shares will be viewed by the IRS as "preferred stock" and therefore be a second class of stock, thereby disqualifying the corporation from having S-Corporation taxation treatment.

In addition to "individuals" and the entities considered as "individuals" that may hold S-Corp shares, certain trusts are allowed to be S-Corp shareholders. These are as follows**:**

1. Grantor trusts under I.R.C. §§ 671-678 [see also Treas. Reg. § 1.1361-1(h)(1)(i)].

2. Testamentary trusts. A trust created by a decedent's Last Will & Testament may hold S-Corp stock for up to two years beginning on the date of the decedent's death. The decedent's estate (not the trust or heirs) is considered to be the shareholder.

The "land mine" that may await many business persons is one whereby the business person (or any family member or other person who receives shares in an S-Corp) does some estate planning by buying one of those "legal in all 50 states" Last Will & Testament kits or a Living Trust kit. The $20 kit may (and frequently does) provide that, upon death, the decedent's property is to be placed into certain trusts or that the shares of S-Corp stock are to be currently held in trust (a revocable trust that will become irrevocable upon the death of the settlor). Subject to the two-year rule stated above, if these trusts do not contain the provisions required by I.R.C. § 1361(d)(3), the trust is not a "qualified" trust; therefore, the S-Corp will be deemed to have a non-qualified shareholder, and therefore the corporation may lose its "S" status. Treas. Reg. § 1.1361-1(j)(6)(ii) provides the procedure for making the irrevocable QSST election to treat a trust as a QSST.

CONCLUSION

The tax practitioner should be especially careful when advising and/or performing tax preparation services if S-Corporations are involved, as one must be aware of the necessity for the S-Corp to pay federal employment taxes and provide withholding of employment taxes from its employees' paychecks. Care should be taken in the classification of workers to ensure that workers are not erroneously classified as non-employees when there is no "rational basis" to classify a worker as a non-employee (e.g., classifying the worker as an independent contractor, or as a mere shareholder, or as an officer entitled to the "minimal services rendered" exception to officers being automatically classified as employees, etc.). S-Corps that have a sole shareholder should designate that sole shareholder as an employee and pay federal employment taxes (based on precedent by the Tax Court and several federal courts of appeal).

Also, courts, including the U.S. Supreme Court, are quick to look at the realities and substance of the underlying economic transactions and not the mere form of the transactions. While there is a very narrow safe harbor that may protect a few taxpayers who are able to meet its criteria, the best safe harbor is for the taxpayer to accurately and honestly determine which persons providing labor for the corporation's benefit are indeed corporate employees and for the corporation to then make the required employment tax payments based upon the employees' reasonable compensation for the services rendered.

Finally, once an S-Corporation is operational, careful attention must be paid to business succession planning and estate planning in order to avoid taking any actions that may cause the IRS to determine that the corporation is no longer qualified to retain its S-Corporation status and therefore be deemed to be a C-Corporation, subjecting the corporation to income taxation at the corporate level.

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