

SMALL BUSINESS | DECEMBER 2009

Small Business Start-up Accounts

By Ryan McConaghy, Mark Sagat and Tess Stovall

On average, an entrepreneur about to launch a new business can expect to spend about \$80,000 in first-year start-up costs. As a consequence, many would-be small business owners must incur heavy debts or cash out their retirement savings to amass the capital they need. Moreover, the credit crunch and economic downturn have made it even more difficult for prospective entrepreneurs to access start-up capital. Tax-preferred Small Business Start-up Accounts would allow entrepreneurs to set aside start-up funding for a future small business while reducing their need to go into debt or deplete their retirement savings.

THE PROBLEM

Entrepreneurs need more help saving to start up a business

Small businesses play a critical role in our economy by providing jobs, driving innovation, and generating economic activity. But the costs of starting a small business can be steep, and there is no dedicated savings vehicle that can help would-be entrepreneurs save needed start-up capital. As a consequence, many budding entrepreneurs put themselves on precarious financial footing by incurring heavy debts or raiding their retirements.

Starting up a small business is expensive.

Even in the best of times, starting a business requires the ability to finance facilities, equipment, advertising, supplies, utility costs, and a host of other expenses. These costs are not insignificant, with the average firm injecting about \$80,000 into a new business during the first year of operation.¹ In light of the fact that between 80%-90% of small business owners make substantial, personal financial investments into their enterprises,² these costs can constitute one of the first hurdles budding entrepreneurs must overcome.

Most entrepreneurs borrow a significant portion of their start-up capital.

While personal financing is predominant, it is not surprising that the heavy burden of start-up costs leads many beginning business owners to also seek outside debt financing. An April, 2009 survey of new entrepreneurs found that 28% used debt financing, ranking this method behind personal finances, credit cards, and retirement plan funds in frequency of use.³ On a dollar basis, outsider debt and owner equity constitute the two largest sources of start-up capital.⁴

In the months since the financial crisis, however, debt financing has been harder to obtain. During the first quarter of 2009, almost 70% of banks reported tightening their lending standards to small businesses. Although that figure has declined to just over 16% in the fourth quarter of 2009, it remains dramatically higher than the 9.6% reported in the fourth quarter of 2007 and is magnified by the fact that none of the banks have indicated that they are easing standards.⁵ The result is an ongoing restriction of credit for small businesses. The decline in loan volumes under the Small Business Administration's 7(a) loan program⁶ underscores this point. Although there have been some recent signs of improvement, the number of 7(a) loans dropped 36% in fiscal year 2009 and the dollar volume of 7(a) loans declined by almost \$3.5 billion, or about 27%.⁷

Many entrepreneurs raid their retirements to start a business.

In an effort to scrape together the cash they need to go into business, 40% of aspiring entrepreneurs dip into their 401(k) or retirement fund.⁸ However, the recession has taken a heavy toll on retirement savings. In 2008, the average worker lost \$10,000, or about 14%, from his or her 401(k).⁹ At a time when the average retiree aged 65 can expect to live more than 18 years into retirement¹⁰ and three out of five retirees are likely to outlive their retirement savings at a pre-retirement standard of living,¹¹ prospective small business owners face the choice of depleting their already-diminished accounts or going further into debt.

THE SOLUTION

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Third Way proposes the creation of a new tax-preferred savings vehicle, the Small Business Start-up Account (SBSA), which would allow prospective entrepreneurs to grow tax-free savings for the purpose of starting up a small business. Modeled after the Roth IRA,¹² the SBSA would allow entrepreneurs to save up to \$10,000 per year in after-tax income and grow those savings tax-free to help ensure access to sufficient start-up capital. Once an individual decides to start a small business, funds in the account can be used for qualified expenses such

as equipment, facilities, marketing, legal fees and other capital and operating expenses. Tax-preferred funds may be used during the first five years of a business.

Funds that are not used for start-up expenses or withdrawn for other purposes would simply lose their tax-preferred status. They would be either taxed as capital gains, in the case of investments, or as ordinary income in the case of dividends and interest.

The tax code provides powerful incentives to Americans to save for their education, their health care and their retirement. However, no dedicated vehicle currently exists to incentivize entrepreneurship and small business growth, even though small businesses are a critical driver of the nation's economy. This proposal would remedy that gap.

SBSAs will help prospective entrepreneurs start small businesses on better financial footing.

By providing aspiring businesspeople with a new savings tool, SBSAs will help to lower one of highest hurdles to starting a new business—amassing start-up capital—by giving individuals a new, dedicated savings option. Since SBSAs will allow for greater amounts of personal savings to be invested in a new business, nascent entrepreneurs will be less likely to raid their retirement savings. In good times, the SBSA will provide businesspeople with a valuable tool to help get their business off the ground with less worry about paying back debt investment. In tougher markets, SBSA funds would be an essential resource that could make the difference between going into business and failing for lack of access to credit.

SBSAs will allow start-ups to be created more quickly.

SBSAs will help businesses go from idea to implementation in a shorter amount of time. Under a scenario in which an aspiring business owner contributes \$2500 per year to an SBSA for ten years, he or she would have a balance of \$37,539 at the end of the investment period. This result would yield an \$18,085 return, \$5546 more than provided by a taxable savings account.¹³ That would be the equivalent of over two years of traditional savings, meaning that more start-up capital would be available more quickly for budding entrepreneurs eager to enter the market.

Boosting small business growth can jumpstart economic recovery.

Efforts to foster vibrant small business growth can play a significant role in turning our economy around. In the recession years of 1991 and 2001, businesses with fewer than 20 employees actually witnessed net job creation, even as larger firms were contracting.¹⁴ Previous recessions and bear markets have not

been shown to significantly hinder the creation of new businesses.¹⁵ During the recovery from the 2002 downturn the number of Americans starting their own businesses rose 5.7%, as opposed to a 1.7% increase from 1997-1998, during the heart of the 1990's economic boom.¹⁶ Companies including Microsoft, Federal Express, Intel, Charles Schwab, Southwest Airlines,¹⁷ and over half of the businesses currently listed on the Fortune 500 were actually started during recessions or bear markets.¹⁸

Moreover, small businesses have proven that they are contributors to American prosperity. They are responsible for generating half of the nation's gross domestic product and employing half of its workforce.¹⁹ These businesses created 60-80% of net new jobs between 1994 and 2004.²⁰ In 2004 small businesses accounted for all new job creation, growing while larger businesses were pruning their workforce,²¹ and in the first quarter of 2007 they were responsible for 74% of net new jobs.²²

THE ROLLOUT

Ideas for rolling out Small Business Savings Accounts

- Hold a press conference/speech with a local individual or group hoping to start a business but experiencing difficulty because of the credit crunch.
- Hold a press conference/speech with a local chamber of commerce or business group to discuss the possible benefits of SBSAs.

CRITIQUES & RESPONSES

Small Business Savings Accounts

It's too expensive.

No, this proposal will create a new tool to help create wealth and improved economic conditions. Making it easier for aspiring business owners to successfully enter the market will strengthen our economy and make some of our budgetary challenges easier to address. It is also worth noting that contributions to SBSA's would be made on a post-tax basis, meaning there would be no forgone revenue on contributions.

Setting up and using this account will be too complicated.

These accounts will be no more or less complicated to invest in and use than the existing Roth IRAs that they are modeled on. These accounts are already used by 18.6 million households²³ to help meet their retirement financial needs. While the ultimate goal of SBSA's is different from the goal of retirement planning the mechanism by which funds will be invested, increased, and withdrawn

will be fundamentally similar. If a Roth IRA is not too complicated for the American worker, an SBSA is not too complicated for the American entrepreneur.

The benefits of these accounts will be insufficient to bridge the gap between personal savings and start-up capital needs.

SBSA's will be a new tool that will help entrepreneurs make their personal savings a more prominent part of their start-up financing mix. They are not intended to be a complete replacement for existing forms of financing, but can provide important, additional resources to help a new business get started. For new businesses every little bit of financing that can be secured without going into debt or depleting other resources can help make the difference between success and failure.

Wouldn't this account be vulnerable to abuse as an income shelter?

No. In the event that an individual chooses not to use his or her SBSA for qualified start-up expenses, funds within the SBSA would no longer be tax-preferred. Non-qualified disbursements would be taxed at the applicable capital gains rate just like any other investment, thereby removing any tax advantage and placing them on a level playing field with mutual funds, stocks, and other investment vehicles.

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■ APPENDIX

Small Business Savings Accounts

Account Structure	Similar to a Roth IRA, in which individuals contribute after tax income with no taxes on qualified disbursements.
Contribution Limit	The contribution limit will be \$10,000 per year, with a life-time limit of \$250,000.
Qualifying Disbursements	Capital costs, equipment, facilities, organizational expenses, marketing, training, incorporation, and accounting fees within first six months. Equipment will be marked from the time of purchase.
Limitations and Terms	SBSAs will be a one-time only financing tool (i.e. limited to one business) and must be fully expended within five years of an initial disbursement. In a partnership, only partners who have not previously used an SBSA for a business venture will be allowed to apply account balances to the new venture. In the event the owner of an SBSA dies before funds are disbursed, the SBSA will be liquidated. Balances will be distributed to a designated beneficiary and taxed at applicable capital gains rates.²⁴
Interaction with Start-Up Deduction²⁵	To avoid duplication of benefits, expenditures of positive return on SBSA investments would not be eligible for the existing start-up deduction.
Enforcement	Non-qualified disbursements would be subject to taxation at applicable capital gains rates.

■ ENDNOTES

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3 In the survey, 76% of respondents indicated use of personal savings, 56% indicated credit card, 40% indicated 401(k)/retirement fund, 28% indicated debt, 13% indicated home-equity loan/mortgage, 8% indicated friends and family, and 0.8% indicated professional outside investors. Riva Richmond, "Starting on a Shoestring," Wall Street Journal, July 13, 2009, available at <http://online.wsj.com/article/SB10001424052970204456604574202171891667550.html>.

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23 Investment Company Institute, "The U.S. Retirement Market, 2008," Research Fundamentals, Vol.18, No. 5, June, 2009, available at <http://www.ici.org/pdf/fm-v18n5.pdf>.

24 See IRS Publication 550 for details on applicable capital gains tax rates and provisions, available at <http://www.irs.gov/pub/irs-pdf/p550.pdf>.

25 See IRS Publication 535 for details on deduction of small business start-up expenses, available at <http://www.irs.gov/publications/p535/ch08.html#d0e5397>.