CHAPTER 5

Drawing the Line:

Business vs. Personal Finances

Contractors who treat their businesses as separate from their personal and family affairs make more money and avoid unnecessary difficulties.

When you run your own business—particularly if you run it from your own home—the boundaries between your work life and your personal life often begin to blur. When I discuss this issue with contractors, they often say, "There's no difference between my business and personal finances" or "My work basically takes up my whole life, so why should I separate it from everything else?" While this might make sense from the point of view of someone who spends 10 hours a day, six days a week on his trade, it doesn't make sense from a business standpoint.

To the contrary, it is very important to keep your business finances and your personal finances separate. This is just as true if you're using a formal type of business such as a corporation or simply working in your own name as a sole proprietorship. Contractors who treat their businesses as separate from their personal and family affairs make more money and avoid unnecessary difficulties. As with other record keeping, make your plan for this before your business year begins. The steps outlined later in this chapter tell you what you need to do and make it as easy as possible.

While there are legal and tax reasons that require you to keep your records separate and clear, it is also something that just makes good business sense. This chapter covers three areas involved in separating business and personal finances:

- Legal and tax issues
- Practical issues dealing with making sound business choices

- How-to steps to help you keep your personal and business finances separate

Q: As long as I follow the tax laws, what difference does it make if I use one bank account for business and personal purposes?

A: If you don't keep your business finances separate from your personal finances, you won't be able to:

- Take full advantage of the tax laws
- Identify all of your business expenses
- Accurately value your business
- Decide if running your own business is better than working for someone else
- Decide if it makes sense to join forces with a partner
- Make an educated decision about hiring an employee
- Think realistically about possibilities for your retirement
- Make the best decisions about new equipment

Legal Reasons for Separating Business and Personal Finances

There are several legal reasons for separating business finances from your personal finances, including compliance with tax laws, meeting the legal requirements of your contracts, and determining a value for your business. Let's start by looking at the tax issues.

Tax laws

As mentioned in the record-keeping discussion in chapter 4, there are many expenses that are deductible from your taxable income. But the tax laws are quite strict about what may be deducted as a business expense. As a general rule, you may deduct those things that are "necessary and reasonable" to run your business. There are two major types of deductions: expenses and capital purchases.

Most of the deductions available to the typical contractor are the expenses involved in running your business. Expenses may be deducted 100% from your gross income in a particular year. Thus, you don't pay taxes on money that is deductible as an expense. The other form of deduction is for capital purchases. Capital purchases are fairly substantial items (such as your truck or a major piece of equipment in your shop) that are considered to be an asset of your business for a number of years. Your accountant or the IRS can tell you which of your purchases are capital purchases and which are expenses.

Unless you file your own tax return, this is all that you need to know. Your job here, and the point of this chapter, is to be certain that the information you supply to your accountant is complete,

Planning Ahead

As with many of the recommendations in this book, you'll find the task of separating business and personal finances far easier if you plan the system you will use in advance of each year and stick to it. You don't want to be thinking of ways to do this while you're working on difficult and profitable jobs for customers. As with the record-keeping matters discussed in chapter 4, you'll find that a carefully planned system will meet your needs year after year and that you will need only to make an occasional minor change.

TIP

CHECK WITH YOUR ACCOUNTANT

This book covers only general guidelines. Remember that tax laws change periodically and that your trade or your situation may have special requirements. Always check with your accountant about your particular case. The IRS can also be very helpful—and free! They have toll-free numbers, a web site that's loaded with information, and people willing to help you with your questions.

clear, and useful. Your accountant needs to know which of your purchases were involved in your business. If you throw all of your money and all of your bills into one big pot, it's nearly impossible to figure out what goes where.

If you spend money on something that has a business purpose and also a nonbusiness purpose, your accountant will need to divide that cost between the business and nonbusiness portion. If you keep those expenses separate, you'll not only save a good deal of your accountant's time (which means a lower bill from him), but you'll also be sure to get every possible deduction (which means you pay less tax). On the flip side, if you don't keep your business and personal finances separate, you not only risk losing some tax advantages, but you also could face difficulties with the IRS or state taxing authorities.

Contracts with customers

Your billings to your customers are based on a fixed hourly rate that you computed including your overhead expenses. If you don't track your business expenses separately from your personal expenses, the numbers that you use to compute that rate may be wrong. Once you have entered into a contract with a customer, your rate is fixed. So, if you got it wrong to begin with and later discover an overhead expense that was buried in your personal account, you'll be out of luck and, worse, out of money.

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Along this same line is the possibility of overlooked charges that you should have billed directly to your customer. These may range from small items such as nails or glue to larger items such as disposal fees for wastes. A contractor may, for example, use the same landscape service to mow his lawns at home and also to do small jobs such as shrub removal at work sites. He doesn't get regular billings from the landscape contractor. In fact, the landscaper may be just the kid next door, and the contractor will pay him out of pocket. "It's just a few dollars," the contractor may say. "No big deal." As months go by, these charges add up, but the contractor can't charge them as job expenses because by the time he recognizes the expense, it's too late to pass it along to the customer. When you do this, it's like giving your money to your customers.

You Snooze, You Lose

Suzanne was willing to follow most of my advice, but the thought of two credit cards was more than she could handle. So when she was getting started in her interior painting and decorating business, she figured out what her hourly rate needed to be and landed her first big contract to do stenciling in four rooms for Janet Wilcox. Janet was pleased with the price that Suzanne put into the contract and so was Suzanne, until her credit card bill came in that month. She had bought all of her stencils, paints, brushes, sample books, and several ladders with her personal credit card and totally overlooked these expenses when she figured her hourly rate and drew up the contract. If these expenses had been kept separately, she would have been much less likely to overlook them and would have made more money on Janet's job.

If you don't separate business and personal finances carefully, you'll also have much more trouble resolving legal disputes with customers. If you're involved in a legal dispute, there is nothing more convincing than a carefully maintained record of the time you have spent on a job and the expenses you have incurred. I have found that more than half of all disputes between contractors and customers are resolved when a contractor sends the customer properly documented records of what he has done on a particular job and what he has spent on it. The contractor who maintains accurate and separate business records shows not only that he is serious but also that he can be very convincing in a court or arbitration proceeding. The best way to avoid trials and hearings is to be prepared for them.

Setting a value for your business

There are times when you need to determine the value of your business: the possible sale of your business, formation of a partnership or other business arrangement with one or more persons, estate and retirement planning, and applying for loans. If you need to determine the value of your business and you have not separated its financial affairs from your personal ones, your job will be very difficult. Businesses are valued in many ways, but their income and expenses are always part of the formula.

Legal Reasons for Drawing the Line

- Tax laws permit you to deduct all necessary and reasonable business expenses but very few personal expenses.
- Separation of business expenses will help you comply with your contracts.
- Keeping track of business expenses separately will allow you to accurately account for all of them.
- Keeping track of business expenses will assist you in resolving some disputes with customers.
- If you need to set a value for your business, you'll need to be precise about your business expenses.

Good-Sense Reasons for Separating Business and Personal Finances

Even if there were no legal or tax requirements for keeping separate records, it's something that you would want to do because it makes good business sense. These good-sense reasons fall into a number of categories that help you:

- Determine what you are really earning
- Decide if your work is worth your while
- Plan for retirement
- Realistically plan for business expansion and major improvements

So, what am I really making?

The first and most important practical reason to separate business and personal finances is that if you don't do this, you won't be able to tell if your business is really making the money that you expect. When I raise this point with contractors, some of them say, "I can tell if I'm making money if I have 'such and such income' left after taxes at the end of the year." Maybe you can, but why wait until the end of the year?

If you have carefully separated your business and personal finances, you'll easily be able to tell at any time whether your work is making enough money to justify it. But if you haven't, you will surely not be able to do this most of the time and, possibly, you won't be able to do it at the end of the year when you do your taxes.

If you have a spouse who also works out of the home, it becomes even more difficult to decide if your business is making money when finances are combined. I know quite a few contractors who work longer hours than their spouses but find that their take-home pay is much less. This isn't always because their spouses really have a greater take-home pay. Sometimes it's because contractors' business finances are mixed up with their personal finances so they don't really know how much they make.

Is your work worth your while?

Carrying the previous idea a little further, if you don't keep your records straight, you'll never know if working for yourself is really worth your time. Suppose you are a contractor who finds at the end of

Who's Really Bringing Home the Bacon?

When Harry met Sally, they both knew that running a plumbing business would be a big-time commitment. And it has been, but now they are both wondering if all the time that Harry spends is really paying him as much as they think and whether it's what they want as a family.

In a typical year, Harry and Sally have a combined taxable income of $58,000. Sally earns about $15 per hour in her job as a computer programmer, and she receives medical benefits and small contributions to a retirement plan as well. Harry's medical insurance is on his wife's policy, and he pays the cost of including him and their two children. Harry has no retirement plan of his own and very little savings.

A friend of Harry's with a moderate-size plumbing business has offered Harry a job as a full-time employee at a starting salary of $30,000. If Harry took the job, he would also receive small contributions to a retirement plan. It's very tempting for both Harry and Sally. Although Harry values his independence, this seems like a good opportunity for Harry to make more money and work fewer hours. Harry wants to know if that's true. He can't answer that until he can figure out how much of the $58,000 combined income he brings home. Only by keeping his business records separate can he answer that question.

the year that you're making $20,000 to $25,000 after taxes and all expenses are paid. If you worked between 1,500 and 2,000 hours that year, that translates to an average of $13 to $14 per hour for your hard work. Pretty disappointing, isn't it? You don't need to run a business with all of its headaches and expenses to make that hourly rate. There may be a value to independence, but even independence has limits.

If you could easily earn the same amount of money working for another person or business, with a whole lot less work and aggravation, it's time to seriously think about doing that. Although the tools in this book will help you to make the income that you want, you'll never really know exactly what you are making if you don't keep your business expenses and income separate from your personal life. Take a look at Harry's situation in the sidebar on p. 87.

Planning for retirement

Another situation where it's important to know the value of a business is when you're considering your retirement plan. Chapter 11 covers the benefits and details that you'll need to know about retirement planning. But you can't begin the process of deciding which plan is best for you unless you have complete and accurate information about the finances of your business. Different forms of retirement plans have different obligations in terms of the money you can or must contribute to them as well as the tax savings that you enjoy. How can you know how much money you really have available for retirement planning if you have combined all of your family incomes and expenses?

Adding partners or employees

The fourth situation where you need to know everything about the finances of your business is when you're considering adding a partner or employee. When I discuss this matter with contractors, they often say things like, "I know that I have enough work for another guy, but I just don't know if I'll make more money if I hire him." That's a good question to ask yourself before you bring on another person. I've heard of many times when a contractor hires an employee but later realizes that even though he is doing more business, the bottom line is that there is less money left over for him.

Only when you have a clear picture of exactly how much profit you make can you run the numbers to see what the effect would be if you added an employee or brought in a partner. Large businesses make decisions about how many employees to hire by carefully analyzing all financial benefits and costs of each employee. On a somewhat smaller scale, this is exactly what you need to do. Chapter 6 talks about how to do that, but you need to have a clear and accurate picture of your business finances before you can start that process.

Planning for Retirement

John, an excavation and foundation contractor, is married to Helen, who is an assistant buyer for a local department store. Their combined gross taxable income last year was $74,000; Helen's salary at the department store was $39,000. John and Helen use one checking account for everything from monthly mortgage payments and repairs for John's expensive backhoe to groceries and pharmacy items for the house. John billed $86,000 for work last year. He has no tax-qualified retirement plan, but he puts $2,000 to $3,000 into a savings account every year, which he calls the "retirement account." Helen has a very small 401(k) plan through her job.

Every time Helen brings up the subject of retirement, John says, "My expenses are so high that I never see more than half of the money that comes in. How can I put money that I don't have into a retirement plan?" John and Helen's finances are so muddled that it's impossible for John to see how he could be putting money into a tax-qualified retirement plan every year without significantly changing his family's finances.

Other major improvements

Before you invest in major purchases or improvements, such as replacing your pickup truck or buying expensive tools, you want to be sure that you really have the money available to do that and that the money is coming from your business.

Methods for Separating Business and Personal Finances

Taxes, legal issues, and sound business choices are the reasons *why* you need to keep your business and personal finances separate. Now, on to the *how*. Once you set up your system, it's pretty simple. There are a few fundamentals:

- Use a business checking account.
- Use a business credit card.
- Don't use your office equipment for personal reasons.
- Don't pay personal expenses from your business account.

Business checking accounts

A separate checking account for business purposes is absolutely essential. Use this account to pay every single business bill, including bills that may be payable to your family personally. When you buy things for your business and family at the same time, use separate checks whenever possible. The reality, however, is that you can't or won't always do this. That's okay as long as your business pays your family for the business part. Here's how: Pay for the entire item with a personal check and write a separate business check for reimbursement of that portion of the amount that is for the business (including the appropriate part of the sales tax). By doing this, you'll have a complete record of all business expenses in your business checkbook. Be sure that this record includes cash expenditures and their purposes as well.

A properly maintained separate business checkbook ensures that you'll be ready for tax time each year and that you'll also be prepared to prove that you have made payments whenever that may be necessary. Don't be shy about writing a check to reimburse yourself for cash you spent for a business purpose. If you purchase something for your business, you're as much entitled to be reimbursed as anyone else.

Your business checking account must also show deposits of all payments from customers and any other monies such as refunds and insurance payments that come into your business. Some contractors record these payments in their checkbooks as soon as they receive them. There are very easy and inexpensive systems for keeping track of all payments and receipts of small businesses. Some of these are called one-write systems. They help you to record your receipts and payments easily and give you complete information to take to your accountant. And if you have a

Always Pay Yourself Back

Brendan went to the store to buy a week's groceries for his family. While he was there, he remembered that he was almost out of soft drinks in his office. He keeps a supply of soft drinks in the small refrigerator in his office to offer to clients during business meetings, so they are a business expense. It makes sense for Brendan to pick them up while he is there but writing a separate check for a few six-packs of soft drinks isn't feasible, so he pays for the whole bill from his personal checkbook. But Brendan knows better than to let his family pay for them. When he got home from the grocery, he wrote a business check to himself to pay for the soft drinks. This may seem silly, but these costs add up over the course of a year and *do* make a difference in the profitability of your business.

computer, there are some easy-to-use computer programs that can help you run your business. Some of them include checking, accounts payable, and even job costing.

Q: What should I do if I accidentally make a purchase that includes some business items and some personal items using my personal checking account?

A: Decide which items are for your business and add up the cost, including sales tax. Make a copy of the receipt for your files. Write a check to yourself for the cost of the business items, and make a note in your checkbook as to what the check was for. File the receipt in the correct folder for your records.

Credit card accounts

If you're like most people today, you use your credit cards more than your checking account. So, just as you need a separate checking account, you also need a separate business credit card. Use it only for business expenses. Your monthly business credit card statement will give you a perfect record of your credit card expenses for your business. Look over your statement each month and mark the purpose of each expenditure somewhere on the statement. You could use "gas for pickup" or "paper for fax machine" for items that have to do with general overhead. For expenses related to particular jobs, the name of the customer is typically enough. If you have several jobs for the same customer or several customers by the same name, make a note such as "Jones warehouse job."

If you have any question about what the expense is for, look at the copy of the receipt that you put in your file folder when you bought the item. (Remember, in chapter 4 you learned to write on each receipt what it was for as soon as you made the purchase and to file it in the correct folder.) When you have a separate business credit card and a separate business checkbook, it isn't difficult to keep perfect records.

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Hands off the office equipment!

Following the suggestions in chapter 3, you should invest in a separate line for your phone/fax. Once you do, be sure to make all of your business calls on that line. And just as important, don't let your family make personal calls from that line, even though it's tempting to do otherwise. When one family member is on your home line, it's easy to duck into your office to make a call from your business line. The same is true for using your fax or copier. Keep your phone, fax, copy machine, and any other equipment and supplies that you have for your business only for your business.

Your business phone and other equipment are costs of doing business. If you share a phone line, you'll need to spend a great deal of time looking over the phone bill each month to separate your business charges from the family charges. With the other office equipment and supplies, you may not be able to separate them at all. Either way, it's a lot of time that you can avoid spending by just keeping them separate in the first place. And don't dismiss the benefits of keeping those business expenses—they can add up to a sizable deduction at tax time.

Use business accounts only for business

I've stressed the importance of not using your personal account to pay for business expenses. The opposite is just as true. Don't fall into the temptation of paying for personal items through your business account. You'll hear people use the expression "running it through the business," which means paying for something out of your business account that has nothing to do with your business. *Don't do it!* First, charging things to businesses that aren't truly business expenses is a violation of tax laws. Small though it may seem, people have been subjected to all sorts of legal actions because of this. The IRS does not look kindly on tax fraud. Second, you are defeating your goal of running a profitable business. If you "bury" personal expenses in your business account, your business will appear to be less profitable.

TIP

WARNING!
Don't pay for anything out of your business account that is not really a business expense. This is a violation of tax laws and a very bad business practice.

Keeping business and personal expenses separate isn't a hard tool to learn to use, but it does take discipline and practice. You'll find that if you stop for a moment each time you spend money to decide whether it's a business or personal expense and if you have both checkbooks and credit cards handy at all times, the process of paying for each expense correctly becomes automatic.

Carefully separating business and personal finances, just as maintaining proper records, may not be the sort of work that is fun for most contractors. If you have help with the office work, you can have your assistant handle this part for you. But however you do this, it is essential if you are to see the greatest possible profit from your business. And you'll find yourself fully prepared for big decisions when you're confronted with them.