<u>TAX MONEY SAVINGS RATES</u>

Income for your business is deposited into your business checking account. Business expenses are paid out of your business checking account. Your net income subject to tax is your business income minus your business deductions. Sole proprietors (filing a Schedule C on their income tax return), partners, and S corporation shareholders take their "profits" out of their business using their **draw** account. If they are professionals or have any other cash basis business, your **total draw** taken from the business is usually a very good indicator of how much money you have earned during the year. (S corporation shareholders need to add their salaries to the draw amount which is called dividends to compute your earnings.)

Your net business income is not subject to income tax withholding. You therefore need to save a percentage of your net income to pay for your income and self-employment taxes due on your 1040 that you file by April 15^{th}. Because your **total draw** from your business is a good indicator of your net income (and therefore subject to tax), I strongly urge you to save a percentage of your **total draw** you take from the business. This tax money should be put in your tax savings account. I use the business savings account that comes with my business checking account for saving my income tax money. I do not use this savings account for any other purpose than my tax money, as I think of this money as a loan from the IRS until my taxes need to be paid.

First determine how much **total draw** is available in your business account to take out. You should write two checks whenever taking a **draw** from your business. One of the checks is your **tax money** that is deposited into your tax savings account. The other check is your **personal money** that is put in one of your personal accounts for spending or savings. Taking **personal money** out of your business without also taking **tax money** out of your business will cause a lot of financial problems at tax time and prevent you from achieving your financial goals.

By isolating your **tax money** in a separate tax savings account and not co-mingling other money with it, I am able to set aside the needed **tax money** to pay my taxes without impacting the rest of my financial plan. Income taxes are automatically provided for and are no longer an issue in my life. As the quarterly estimated taxes come due, I take the **tax money** from my tax account to pay them. Also, any balance due April 15^{th} will be available in my tax savings account as I have saved for my taxes based on my current year's income.

The key to making this flow of money work is to determine the proper percentage of your **total draw** that needs to be put into the tax account as **tax money**. Also extremely important, is to understand how to compute the amount of **tax money** you need to set aside. Properly computing the tax savings rate can be very confusing for many people. Failure to save enough **tax money** can lead to under funding your tax liability and having a large balance due on April 15th without having the money available to pay the tax.

Whenever you take money out of your business as a draw, you need to set aside a percentage of the money in a separate tax account. The percentage of **total draw** you need to set aside can vary from as low as 20% to as high as 60% depending on your individual tax circumstances. A single income family operating as a sole proprietor in Washington state earning more than $50,000 will generally use 33 1/3rd % as their tax savings rate. The same family in California or another state with a high state income tax can have a rate of 38%. If you have a spouse who is earning a high income, or both spouses have high incomes, your tax savings rate can be higher. Someone who is earning less in their early years may have a lower rate for tax savings.

I would strongly urge you to ask your CPA or other tax advisor to calculate your estimated tax savings percentage of your **total draw** for your particular circumstances. It is important to use the rate based on your expected income rather than your prior year's income as your practice income can change substantially from year to year. I also urge you to have one or more income tax projections done by your CPA or tax advisor during the year. If you are not saving the correct amount of tax, it's better to know in August rather than next April. I always try to slightly over fund my tax account to avoid nasty surprises on April 15th. When I calculate my tax liability in the spring, any excess amounts in my tax account are transferred into my personal savings or investment accounts as additional savings.

Your tax savings percentage or rate should be based on your **total draw** amount taken from your business account **<u>including</u>** the tax part of the draw. For example, suppose you have $3,000 to take out of the business as a **total draw**. If your tax savings rate is 33 1/3rd, $1,000 is **tax money** and is put into your tax account. The other $2,000 is **personal money** and can be put into one of your personal accounts. Thus, your **tax money** of $1,000 is 33 1/3rd % of the **total draw** of $3,000. If you put $3,000 of **personal money** into your personal savings account, what is the correct amount of **tax money** to put in your tax account? If you multiply the $3,000 by 33 1/3rd % to come up with **tax money** of $1,000 you are under funding your taxes. Because you have already taken out the $3,000 as **personal money** and then add the $1,000 **tax money** to the tax account, your **total draw** is now $4,000. You have put $1,000 **tax money** or 25% of the total away for taxes, rather than the correct tax savings rate of 33 1/3rd %. The correct amount to put away into your tax account is $1,500. Your **total draw** is the $3,000 **personal money** **<u>plus</u>** the $1,500 **tax money** for a **total draw** of $4,500. The $1,500 **tax money** is 33 1/3rd % of the **total draw** of $4,500.

The distinction you need to make is between calculating the tax savings rate as a percentage of **total draw** including **tax money** coming out of your business account Vs. calculating the tax savings rate as a percentage of the **personal money** you are putting in your personal account. In the previous example, if you calculate the tax savings rate as a percentage of the **personal money** going to your personal account, the rate is now 50% of your **personal money** because we are working off a different base. Your tax savings,

$1,500 is 50% of the $3,000 **personal money** going into your personal account. It is also 33 1/3rd % of your **total draw** of $4,500.

Total Draw is the amount of money you are taking out of your business account.

Tax Money is that portion of your **total draw** that is needed for your income taxes.

Personal Money is the part of your **total draw** that is yours to keep after taking out your **tax money**.

Total Draw equals **personal money** plus **tax money**.

Personal Money equals **total draw** minus **tax money.**

Look at the differences in tax savings percentages based on **total draw** of $1,000 Vs. tax savings percentages based on **personal money**.

A Total Draw	**B** Tax Savings % of **Total Draw** **(D divided by A)**	**C** Tax Savings % of **Personal Money** **(D divided by E)**	**D** Tax Money	**E** Personal Money
$1,000	20.00%	25.00%	$200	$800
$1,000	25.00%	33.33%	$250	$750
$1,000	30.00%	42.86%	$300	$700
$1,000	33.33%	49.99%	$333	$667
$1,000	35.00%	53.85%	$350	$650
$1,000	38.00%	61.29%	$380	$620
$1,000	40.00%	66.67%	$400	$600
$1,000	45.00%	81.82%	$450	$550
$1,000	50.00%	100.00%	$500	$500
$1,000	55.00%	122.22%	$550	$450
$1,000	60.00%	150.00%	$600	$400

Column **A** is the **Total Draw.** It is the amount of money available to take out of the business.

Column **B** is the Tax Savings % of the **Total Draw**, Column **A**.

Column **D** is the **Tax Money.** It is the amount of money that should be put in the tax account. It is calculated by multiplying the **Total Draw** of Column **A** times the Tax Savings % of Column **B**.

Column **E** is the **Personal Money.** It is the amount of money put in your personal account for personal use. **Personal Money** is the difference between your **Total Draw** and your **Tax Money** (Column **A** and Column **D**).

Column **C**, the Tax Saving % of **Personal Money** is the amount of Tax Savings $ in Column **D** as a percentage of your **Personal Money** in Column **E**.

You can see that if you base your percentage on the wrong draw number, the **Personal Money** instead of the **Total Draw**, that your tax saving percentage will be incorrect and you will under fund your tax account. When you discuss your situation with your CPA or tax advisor be sure that you understand which percentage computation to use, Column **B**, the Tax Savings % of **Total Draw**, or Column **C**, the Tax Savings % of **Personal Money**.

My preference for my own savings and when I communicate with my clients is to use the Tax Savings % of **Total Draw**, the Column B percentage.