

Mistakes in Home Business Accounting

It's early in 2008, and no doubt many people are thinking seriously about starting a business. Many of these businesses will start in the home, as mine did. So here are some mistakes to avoid in starting that home business.

Set Aside Money To Pay For Taxes

First, you won't have any taxes to pay if your business doesn't make a profit. Sounds simple, right? Profit means revenues (collection on sales) minus deductible expenses. In a business that is just getting started, it's entirely possible to lose money. Expenses exceed revenues. In this case, since there is no income (profit), there is no tax.

But when you start to make a profit, you will pay substantially more taxes than you probably think you will.

Federal income tax is the one most people think of, and comes as no surprise. But don't forget that the state wants its share, as well. So State income tax is a second tax. Fair enough.

Self-employment tax, or your contribution to Social Security and Medicare, is the one that comes as a huge surprise. When you had a day job, 7.65% of your income was withheld by your employer for your contribution into the federal government's trust fund.

Your employer matched your contribution with another 7.65% from the business. Your total contribution, therefore, was a cool 15.3%.

Now you're self-employed, and guess what? The government doesn't want you to be short-changed on your contribution into the Trust Fund, so as a self-employed individual, you get to make both the employee's contribution as well as the employer's contribution. The entire 15.3%.

You'll get a tax break for the "employee's" share, but you will be expected to make the full 15.3% contribution. The thinking is that if you contribute any less, you will be disadvantaged come retirement time: you won't have as much money in the system.

For many self-employed people, their Self-Employment tax is greater than the income tax! Personally, I think there is something bad wrong with America when that happens, but that is reality. So, set aside enough money to pay taxes.

Keep Expense Receipts

Really, there are two reasons for keeping these receipts. You're thinking of one reason—gotta be able to prove the expense if you're ever audited.

Proving the expense is indeed one reason to keep them. The other reason is more subtle—you've got to have an organized method of recording the expense.



For some reason guy owners are much, much worse about this than are gal owners, by the way. Classically what happens is the guy owner withdraws "walking around" money. It's always an even number, and usually is a multiple of 100.

So we see withdrawals for \$200 or \$300, which happens all throughout the year. We all know that much of this money is spent on legitimate company business, meaning deductions. But without documentation, there is no way that the expenses will ever get on the company books, much less be proven in event of audit.

It's an easy fix: Explain to the guy owner that he has a shirt pocket. The expense receipt goes in the shirt pocket. And it comes out when the owner gets back to his office goes in a special place reserved for Accounting.

I don't have an equivalent fix for lady owners, but they don't seem to be a problem in this regard.

"Treat All Deposits As Income"

This phrase has become almost a mantra to IRS and to those of us who work with small business accounting. The basic idea is simple: If we (or IRS) can't tell, we just treat all deposits as income, and hence exposed to taxation.

As we all know, most deposits are indeed income. But not all. Not that \$10,000 you initially put in to start the business, and not the \$5,000 you had to put in later.

But if you don't have a mechanism to distinguish between taxable income from sales, and non-taxable deposits such as loans or refunds, you could very well overstate your revenues and hence your taxes.

I have seen this happen in IRS audits. They'll add up a year's worth of bank deposits, and compare it to your annual sales. It's entirely OK to have more deposits than sales, but you'd better be able to prove where the difference came from!

In one case deposits were \$40,000 more than reported sales. When the smoke had cleared, the IRS bill was \$25,000!

All deposits treated as income.