Tax tip: a personal savings plan that works

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As a parent of two teenage kids, the concept of going freelance originally scared me silly. In particular, I'd never really run a business before and accounting was just one of those things my brain never seemed capable of handling. (It turned out to be easier than I'd feared, fortunately.) One of my biggest worries was how to ensure that come year-end, I'd have enough money left over to cover my tax liabilities.

A little thought provided a solution that works particularly well for me and that keeps me from spending money I don't have. Better still, it creates an enforced savings plan I can live with and that requires minimum overhead on my part. In this article, I'll describe how it works.

But first, a word of caution: It's important to remember that as freelancers, we must always keep a well-stocked reserve of money, often referred to as an "operating reserve" or "emergency fund", that will cover our expenses for at least 3 months and preferably for longer. This sum is what we'll survive on during dry spells when there's no work, or during life crises such as a sudden injury or illness that prevent us from working. The only goal of the reserve is to keep us financially alive until our business revives or our disability insurance kicks in. If you haven't built up such a reserve, creating one should be a priority. I built mine slowly by forcing myself to put aside money while I was a wage slave so that it would be ready when I made the leap.

My solution was to create a very simple spreadsheet that I use to track my income and expenses. The "income" page contains the following columns:

- Column 1: Details on the work—often just an invoice number that contains the client's name.
- Column 2: The fee charged for the service, excluding relevant taxes.
- Columns 3 and 4: Federal and provincial sales taxes. (In the U.S., replace "provincial" with "state".)
- Column 5: The total of the previous three columns.

At the bottom of the spreadsheet, I total each of the numerical columns, thereby providing a constantly updated running total. Below these totals, I have three additional rows, each of which represents one of the three overall Canadian tax brackets. For each row, I calculate my income tax based on the tax rate for the corresponding tax bracket, but here's the trick: *I don't include any personal deductions or exemptions* in that calculation. The result is that the column totals for sales tax tell me my total sales tax burden, and the row totals for each tax bracket tell my my maximum income tax liability. (With a little more sophistication, I could create a single formula that calculates the tax liability, but I was still learning the basics of Excel when I developed this approach.)

Each time I add a new paid invoice to the spreadsheet, my maximum tax liability (income plus sales) is updated at the bottom of the sheet. When I deposit each new cheque at my bank, I pause for a moment to ensure that the current balance in my financial reserve—a special short-term savings account that I'll describe in more detail in a moment—is larger than my total tax liability based on the spreadsheet. If not, I transfer enough of the new cheque to top up the account and cover my liability. Anything that remains becomes disposable income. By the end of the year, I not only have enough money to pay my taxes, but I also have an additional sum (usually a large one) that arises

from how I chose to calculate my taxes: with no deductions or personal exemptions included, the *calculated* tax bill will always be higher than my *real* tax bill. Barring any emergency expenditures that force me to dip into my reserve, I'll always have money left over at year-end. Some years, I even get a tax rebate on top of the enforced savings. In any event, any extra money that isn't required in my short-term reserve goes straight into retirement or other long-term savings.

The "short-term savings" account that I referred to earlier is more than just a regular bank account, because such accounts pay essentially zero interest. In my case, it means a money-market mutual fund that earns a steady, unspectacular rate of return with maximum security because the money is all invested in government bonds and similarly safe investments. The low interest rate is an acceptable trade-off for obtaining high security and near-immediate liquidity: I can extract the money with 1 day's notice, and there's no "load" (purchase or redemption charge) to either buy more units of the fund or redeem existing units when tax time rolls around. If you have more money available and are willing to lock in your savings for longer periods, "guaranteed investment certificates" (Canada) or a "certificate of deposit" (U.S.) may make more sense because these investments often offer higher rates of return. If you're a gambler, you can invest in riskier but higher-return investments such as stock funds, but I don't recommend this approach; the sole purpose of this savings account is security and liquidity, not a high rate of return.

Your financial circumstances may dictate a slightly different strategy. For example, if you're living hand to mouth, you may have little money left over to top up your reserve. Conversely, if you're earning far more money than you need to cover your expenses, you can make additional deposits or top up your long-term savings. The key is to have the discipline to sacrifice a little bit of comfort while you're building up your reserve so that you can relax a bit and spend more freely in the future. It's worked like a charm for me, and with a little modification, it'll work for you too.