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Personal Finances for the Physician: A Primer on Maintaining and Protecting Your Earnings

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Summary: Personal finance is a key component to your success as a physician. Your clinical practice does not exist in a vacuum unaffected by circumstances and decisions in your personal life. Though some events in your personal life that can negatively affect your practice are random and unavoidable, consistently making sound decisions regarding your personal life and finances will allow you to continue practicing at a high level. Most core principles of personal finance are common sense and do not involve high level math. Although the concepts are straightforward, people, including physicians, routinely fail to make good decisions at the most elementary level. The core common sense principles for financial success are: do not get divorced, manage your own money, live in a state without state income tax, and drive an old car. Follow these tenants and the path to successful and satisfactory retirement will be smooth.

Key Words: personal finance, wealth management, insurance, employment contracting

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BASIC TENETS

1. **Treating** your spouse like a partner: Your first marriage is always the cheapest! Your spouse has endured much of your hardships by proxy so do not ignore their patience and assistance with everything outside of your practice. Divorce is the quickest way to reduce your financial portfolio. Depending on your business structure, indemnification clauses, and other protective measures, your soon-to-be-ex-spouse may have a claim to a portion of your practice. The emotional and financial strain of divorce can greatly affect your medical practice, so whenever possible, keep it together.
2. **Enlisting** professional help and guidance for wealth management, financial planning, and asset protection is necessary to establish a successful and sustainable plan. There are three primary ways to pay those individuals depending on your level of desired involvement. One method is to meet with an advisor and pay them a fee to develop a plan for you. You would provide them with your goals/objectives/concerns and they would develop a plan accordingly. On an ongoing basis, you likely would meet with them once per year to review and modify the plan where appropriate. This is primarily fee-for-service and/or by time. Each year you pay your advisors for specific tasks that consume a defined amount of their time. You are billed for that time but not for an annual management fee. Option two is to pay a yearly fee or percentage of assets to your attorney's and financial planner respectively. This approach may cost more over time as opposed to a pay-as-you-go arrangement, however you are also receiving significantly more in terms of service, ongoing expertise, asset management, comprehensive delivery and coordination of information is to pay a yearly fee or percentage to your financial planner and estate planning attorney. These annual fees when you take into account the power of compounding interest that you forgo by paying the professional a yearly percentage adds-up over the course of your career. Option three is a combination of the two aforementioned items. You pay a fee for the plan and related services on an annual or as needed basis. You then pay a fee for assets under management. All three are regular and available options. It's critical to determine how involvement and how much follow-thru you will have on an ongoing basis and identify the best approach for you.
3. **Tax** management: Tax diversification is an important financial consideration and should be viewed in the same manner as a diversified investment portfolio. Deferring all of your taxes may initially seem like a good idea, but if you could have paid 35% income taxes initially but deferred to a time later in life and the income tax rates increased to 55% or more, your entire savings plan could be in jeopardy. Each state generates revenue from their tax base in a variety of ways. Some states rely heavily on personal income tax and less on corporate or consumer taxes. Property taxes can also be a significant source of revenue for the state. Although there are a myriad of tax credits, exemptions, and reductions for each tax vehicle, income tax is taken out before you ever see it. The sooner the government entity extracts cash from you in your revenue stream, the more likely you are to pay the tax. States without income tax are advantageous because you can always decide what properties to buy and what consumer products are necessary to purchase and limit these as necessary. You do not want to limit your income which is the only guaranteed way to pay less income tax. State income taxes range from 0.5% to 15%. As a physician, you will usually be in the higher bracket within the state and, over the course of your career, the income tax paid significantly affects your retirement planning and net earnings potential.
4. **Keeping** a low profile (risk minimization): Pulling up to the office or hospital in the red Ferrari is the best way to

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paint a target on your back. The patient who is undergoing surgery at your hands, suffering through pain and uncertainty, cannot identify with a Ferrari owner and will have a more difficult time believing you understand them as a person. It also creates the perception that you have deep pockets that can be pilfered by attorneys. If you want to buy a Ferrari and have the dispensable income, go for it—just don't drive it to work.

5. **Budgetary** responsibility: It is imperative that you take the time to sit down with your spouse and possibly an accountant to review your annual expenses broken down monthly. There are 2 general budgeting philosophies most commonly employed by physicians. No matter what plan you choose, make sure you pay yourself now and in the future (retirement).
   - Determine your monthly budget, have that amount deposited into your checking account automatically each month, and have the rest deposited into your different retirement, liquid savings, and additional investment accounts. The rationale behind this method is that most people will spend up to their limit regardless of what it is.
   - Spending the "leftovers." After making contributions to all of your established retirement, savings, and investment accounts, the remaining funds are transferred into your checking account for you to spend.
6. **Above** all be a good person and do what is right: This simple concept is acknowledged by most physicians but many fail to consistently implement it, causing disruptive conflicts within their personal and professional lives that significantly interfere with their financial success.
7. **Debt** management: The key to evaluating debt payoff is a combination of your paradigm, or the lens through which you see debt, as well as the hard numbers of the debt in question. In our experience, people approach debt with 2 primary anchors: *financial sensibility* and *emotional sensitivity*. Financial sensibility involves evaluating 2 options, whereby if you had extra money in your budget on a monthly basis, would you financially be better off if you applied the money toward debt or to savings/investment. Emotional sensitivity involves your feelings about debt ranging from deep rooted discomfort, bordering on hatred, for debt no matter what the interest rate is, to total comfort. No matter where you fall within this spectrum, most financial advisors would agree that attacking the debt with the highest interest rate first is usually a sound fiscal approach.

BEFORE YOU START YOUR CAREER: PLANNING CONSIDERATIONS WHILE IN TRAINING

What are the top planning considerations while in training? In our opinion, there are 3 planning strategies to evaluate while in training: 1 is investment related and the other 2 are risk management related.

Fund a Roth IRA

You might say, "Why is it so important to fund a Roth IRA when I have such limited resources available to me?" The primary reasons are two-fold.

- You might not be able to utilize a Roth once you complete training because you will make too much money. "Too much money?!" Yes, once your income exceeds certain levels (as of the printing of this book the income limits for a single household are $121,000 adjusted gross income and for married couples $191,000 adjusted gross income to fully contribute), it's quite possible the only years you are able to contribute to this vehicle will be while you are in training.
- The benefits of compound interest in a tax-free account are significant when considering long-term growth and future tax brackets.

Acquire Disability Insurance/Protect Your Income

In our opinion, arguably the most important financial decision you will make upon deciding to become a doctor is to protect the investment you made in yourself. In other words, if you are unable to work as a doctor due to disability, you will continue to collect tax-free income from your disability policy.

Consider Life Insurance If You Have a Family

Many of the people we have met through the years have asked a couple of questions regarding life insurance. The first question is, "If I do not have much money but I want to protect my family in the event I die what type of life insurance I should consider?" The second question is, "I have heard you should only by term or whole life insurance. What is your perspective?" The first question is relatively simple to answer in the sense that people are able to acquire relatively inexpensive term life insurance to protect their family. Further, you could purchase term insurance which affords you the ability to convert to permanent coverage in the future if appropriate for your situation.

During training, while your income is presumably much lower than it will be in practice, a new physician would be wise to begin taking stock of good budgeting and spending habits.

Establishing the Parameters of Your Professional Services: Employment Contract

Employment contracts for physicians are the norm and must be reviewed and understood. Sections of the agreement to pay particular attention to include:

- Compensation
- Malpractice insurance
- Scope of duties
- Limitations on outside activities
- Bonus or profit-sharing options
- Benefits
  - Vacation
  - Medical education reimbursement
  - Medical benefits
  - Retirement programs
- Philosophy of the hiring institution

Of these, compensation and malpractice insurance stand out. Compensation is the point of the agreement and the amount you make is an indication of not only of what the organization thinks of you, but also what you will have as a resultant lifestyle. The arrangement must be examined

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based on the total compensation: actual pay, bonuses and incentive pay, reimbursement for medical education, relocation reimbursement, medical benefits, student loan repayment plans, car allowance, retirement benefits, and insurance payments and coverage are some of the items to consider. Malpractice insurance is typically the largest cost to any physician. An understanding of claims made policies, occurrence-based policies, and tail coverage is critical.

Wealth Management

Retirement Planning: How Much Is Enough?

One of the most important yet impossible questions to answer for retirement planning is how much money is enough to retire on. This number is different for every individual so we will briefly touch on the basic elements that affect this number. To estimate the dollar amount needed to retire, you have to decide how much money you need per month to live on and whether you plan on leaving anything to future generations. Once you have an estimate for your living expenses per month you have to determine at what age you would retire and how long you are likely to live afterward. You must determine the projected rate of return, for the purposes of this exercise 6.5% will be used as this is the average real rate of return over the last century. Finally, you have to adjust for inflation which has averaged 3% per year over the last 20 years and is typically used as the benchmark for investment analysts. Next, you must decide whether you will live off the interest only or use the principal from your retirement fund also. If you leave the principal intact, this can be left to future generations. This arithmetic exercise is best demonstrated by example (Table 1).

This is clearly a simplification of a complex, multifaceted calculation. Important to note is that any funds in a 401 (k) or similar tax-deferred plan will be taxed at the normal income tax rate which is currently scheduled to increase to 39.6%, but could go even higher in the future. If you want to use the principal to supplement your monthly income in retirement, the calculation is identical to an annuity. Once you have determined the amount you need to retire on, you then can calculate how much you need to save per month to reach that goal. If your retirement age is lower, you will need to save substantially more money per month as you have less time to save and more time to spend.

TABLE 1. Sample Retirement Planning Exercise

Projected monthly expenses: $10,000
Start date: January 1, 2013 (age 33 y)
Retirement date: December 31, 2045 (age 65 y)
Inflation: 3% per year
Life expectancy: Age 95 y (December 31, 2075)
Principal use: No
Rate of return: 6.5%
Results
Value of $10,000 adjusted for 3% inflation in 2045 = $24,273
Yearly value adjusted for inflation, after taxes = $291,276
Yearly value adjusted for inflation, pretax (capital gains rate 20%) = $364,095
Principal needed to retire = 364,095 (yearly pretax need)/0.065 (rate of return) = $5,601,461

How Do You Save?

In order to effectively save for the future you must avoid spending all of your income. Although this sounds incredibly obvious and straightforward, the implementation does not always occur. Regardless of what your spending habits are, determine a plan to withhold some of your earnings every month for short- and long-term savings and be consistent.

401(k), 403(b), and Analogous Tax-Deferred Qualified Retirement Plans

The most valuable features of 401(k) plans are the possibility of employer matching funds, some degree of asset protection, and the ability to defer taxes. The annual maximum contribution allowed to a qualified tax-deferred retirement account is currently $52,000 per year for high income earners. This amount can be deducted from your taxable income, but you will have to pay taxes at the normal income tax rate once it is withdrawn. The funds can be withdrawn starting at age 59.5. Using the above example for time frame, by contributing $52,000 per year for 32 years earning 6.5%, the balance at age 65 would reach approximately $5.22 million which would be taxed at the normal income tax rate, 39%, leaving a balance of $3.18 million.

If you retire at 59.5, the age which you are allowed to start withdrawing funds from your 401(k), your balance after taxes drops to $2.11 million. Also, this smaller sum of money has to last 5.5 years longer since you retired earlier. This demonstrates the power of compounding interest and time. This also demonstrates that relying on a 401(k) plan as the sole source of your retirement income is not an ideal strategy. Retiring at age 59.5, after taxes you could receive approximately $5000 per month (adjusted for inflation) for 35.5 years, leaving nothing for future generations. Funds in tax-deferred accounts can be converted to Roth IRA status by paying taxes at the nominal rate and then allowing the funds to continue to grow tax free.

Qualified Tuition Plans (529): Rules, Limitations

Qualified tuition plans or 529s come in 2 general varieties: tuition prepayment plans and savings plans. The tuition prepayment plans typically are for state universities and allow you to lock in the current tuition rates. A total of 529 savings plans offer more flexibility but do not lock in current tuition rates. All 529 plans are state-specific education savings plans that are not tax deductible but do allow for contributions to grow tax free if the distributions are used to pay for postsecondary education at eligible educational institutions. Eligible expenses include tuition, books, and room and board. The rules governing which institutions are eligible may differ from state to state, but it provides even high income earners an opportunity to let some of their income grow tax free which is a powerful investment tool.

Estimates of the cost of a college education 20 years from now vary greatly, but rest assured, it will increase. It is not unreasonable to plan for a total cost of $300,000 per child for an undergraduate education. Additionally, many graduate degree programs also qualify. Funds within the 529 account can be rolled over to other family members other than the

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beneficiary to pay for qualified educational expenses without penalty. If funds in a 529 plan are withdrawn and not used for qualified educational expenses, they will be subject to taxes and an additional 10% penalty. For a family of 3 children, contributions of $2000 per month for 18 years yield a total contribution of $432,000. The growth of this at 6.5% would yield a total value of $828,401. The capital gains tax savings in this example is over $79,000. Because these plans can also be set up for grandchildren, 529 plans can be important estate planning tools as well. To properly utilize a 529 plan, it is important to consult a tax or retirement planning expert in your state familiar with 529 plans.

Additional Savings: Bridging the Gap Between Your Retirement Goals and 401(k) Plans

After you have determined your estimated monthly retirement income, adjusted for inflation, and the projected balance of your 401(k) retirement plan, you can calculate the additional monthly savings needed to reach your individual retirement goals. We expand on the example above to keep the math simple (Table 2).

Cash Value Life Insurance

The utilization of cash value life insurance as a retirement investment vehicle is the subject of significant controversy. There are strong arguments for and against this strategy, and it would be wise to consult multiple financial advisors before dedicating a substantial portion of your savings toward this strategy. The general principle is that significant premium contributions accrue a cash value in addition to a death benefit value of the policy. The cash value then grows at a determined rate, usually relative to an equities index. There are significant fees in addition to the premiums that have to be taken into account as well. Theoretically, once the policy has accumulated a substantial cash value, the dividends can be used to pay the premiums, thus eliminating the need for further out-of-pocket expenses. Also, once a certain cash value and time point has been reached, the investor can take out a loan from the insurer against the cash value. Because it is a loan, it is not taxed as income. Taking out the loan lowers both the cash value and death benefit value, but the loan is not repaid because the individual eventually dies. There are limits to the amount that can be loaned out without incurring taxation, and there is also the unknown possibility of congressional lawmakers changing rules that would eliminate this as a legitimate investment avenue.

TABLE 2. Sample 401k Planning Exercise

Retirement age—65
Years of contributions—32
Monthly income required—$10,000 ($120,000/y)
Yearly income adjusted for inflation after taxes—$291,276
Value of 401(k) at age 65 y—$3.18 million, after 39% income taxes $1.94 million
Use of principal—No
After taxes, distribution of $100,880/y from 401(k) plan
Shortfall of $190,396/y for a monthly retirement income of $10,000
Additional savings needed—$3.66 million
Additional savings needed—approximately $2,900/month × 32 y

Health Savings Account

As of 2003, individuals who have qualifying high deductible high premium (HDHP) life insurance plans can contribute up to $3250 for an individual or $6450 for a family per year to a health savings account (HSA). The contributions have significant tax advantages. The contributions are tax deductible, the funds can then grow tax free, and can be withdrawn at any time tax free if they are used for qualifying healthcare expenditures. Any remaining funds at the end of the year are rolled over into the following year. The HSA transfers to the spouse at death without penalty if the spouse is listed as the beneficiary. It is the investor's responsibility to know when they have met the maximum annual contribution and whether the healthcare expenditures qualify. If funds are withdrawn from the HSA and not used for qualified health expenditures, the funds are taxed at the normal income rate and a 20% additional penalty is incurred. However, if the funds are withdrawn after age 65 and not used for medical expenditures, there is no penalty. The gains realized would be subject to normal income tax identical to a 401(k) plan.

Alternative Revenue Streams: Real Estate

Physicians typically have a consistent, long-term ability to produce income and therefore capital. It is not uncommon for a physician to be inundated with "investment opportunities" from family, friends, acquaintances, and random individuals. When handled properly, leveraging a portion of your income can be a very effective investment strategy. The risk of investing in individual business opportunities is typically higher than with mutual funds, bonds, or even large cap equities. However, with risk comes the opportunity for greater reward. One of the most common ways physicians leverage their income is through real estate investing. Real estate is attractive because it has both intrinsic and functional value, increases in value over time, can be used for personal enjoyment, and can provide a steady stream of revenue. Property management companies can obviate the need for the physician to be a landlord regarding the day-to-day operations and can also insulate the property owner from the tenants. Although properties both commercial and residential make good long-term investments, the initial evaluation of property value and earning potential are critical. The best advice I have heard regarding real estate investing is the following admonition: you do not make money on day 21 or month 21 of a real estate deal, you make money on day 1. If the price is right and the pro forma is accurate.

Tax Diversification

Avoiding taxation may be illegal, but minimizing your tax burden is important at all stages of wealth accumulation and estate planning. Estate taxation is addressed later in the chapter along with estate planning, so this section focuses on tax diversification and considerations while you are working.

Many clients focus first and foremost on the question of how to lower their tax liability now. While this question is important, one should also ask: "How do I lower tax liability as I grow my wealth?" and, "How do I lower my tax liability

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when distributing my wealth in the future?" We have witnessed a majority of people focus primarily on saving taxes today with little regard for the impact of taxation during the accumulation phase, and virtually no thought as to how taxes will impact their net wealth in the future.

Today

Taking advantage of your pre-tax savings plans such as a 401(k), 403(b), SEP IRA, or profit-sharing plan will lower your tax liability in the year in which you contribute. For example, if you earn an annual income of $350,000 and contribute $49,000 of that to your employer-sponsored 401(k) or profit-sharing plan, you would lower your tax liability by approximately $18,000 for that year. Notice we didn't say "save" money in taxes, but strategically used the word "lower" to describe the effect. In our opinion, this is more than a simple matter of semantics because it is important to remember that at some point you *will* pay taxes on these monies. Where do you think federal tax brackets will be when you access this bucket of wealth? Based on demographics alone (the number of baby boomers in this country will double in the next 20 years), the likelihood of federal tax brackets increasing is high due to the incredible strain placed on Social Security, Medicare, and Medicaid. Couple this demographic shift with the heavy spending in the previous and current administrations and 1 conclusion comes to bear: Your retirement allocation must be balanced accordingly between taxable and tax-free sources of income.

During Your Career

Here are some important considerations while you are earning income and building your wealth:

- Are your assets growing tax efficiently?
- Are you maximizing your growth using the impact of compound interest?
- Are your investment vehicles adding to your tax liability?
- Further, what is the lost opportunity cost associated with these taxable investments?

To illustrate these questions, consider this example. Imagine that your investments for the year generated a $10,000 tax bill due to capital gains tax, etc. The lost opportunity cost represents how much that $10,000 may have grown over 30 years if your assets had been structured in a tax-efficient way that allowed you to avoid the tax and keep the $10,000 invested.

A simple tip to help you determine how much your money will grow is The Rule of 72 whereby you take your expected rate of return and divide that number into 72. The resulting number reflects how many years it will take for your investment to double. Therefore, using our example above, and estimating an 8% rate of return, the $10,000 would double every 9 years. That would result in $40,000 in 18 years, and $80,000 in 27 years. To express the true impact of paying this tax, we often say to clients: "It's about much more than the $10,000 in extra tax you are paying today; it's also about losing out on the $40,000, $80,000, or more that you sacrifice by not investing tax efficiently."

Retirement and Beyond

As you begin to withdraw money for living expenses from your various retirement accounts, the drains on your wealth include: the rising cost of living, medical care, and taxes. Many have been led to believe they will be in a lower tax bracket in retirement than they were pre-retirement. Are you one of them? For most investors, this notion is misguided for several reasons:

- You will no longer have retirement contributions lowering your tax liability.
- You likely will not have the interest deduction on your home.
- You likely do not wish to lower your standard of living? Or perhaps you will.

Here is the deal. If you are a diligent and disciplined saver, you should expect to have a fairly significant net wealth at age 60. This said, even if you only peel off enough income to keep you in a lower tax bracket in retirement, you likely are taking less than the interest will be earning. The result is that your wealth continues to grow. Think of a snowball going down a hill: it grows largest at the bottom!

If you only peel off a small amount relative to the entire balance you are setting yourself up for a vital challenge. The Internal Revenue Service Age 70.5 Required Minimum Distribution (RMD) rule carries a heavy burden whereby the IRS becomes your business partner and dictates all the terms. Effectively, you must begin mandatory withdrawals from your tax-deferred qualified retirement accounts (401[k], SEP, 403 [b], profit-sharing plans, etc.) at a pace quickly enough to liquidate those accounts by your estimated mortality (if you don't elect this distribution, in addition to taxes, you are hit with a 50% penalty). For example, assume you have $4 million in your taxable accounts at age 70½ (remember, these monies are taxed at distribution) and you are earning 4%. Let's also assume an age 85 mortality rate. In this illustration, the Required Minimum Distribution would require you to withdraw 1/15 of your principle balance annually—roughly $267,000 in addition to the interest of $160,000. The IRS will now have more control over your tax bracket than you do.

1. Potential benefit of a professional limited liability company (PLLC) taxed as an S corporation for doctor business owners:
   - Allows the business owner to bifurcate clinical service hours provided to the business from the role as owner of a practice, particularly in a situation where there are multiple providers;
   - Allows the business owner the ability to better isolate their more aggressive tax-deferred retirement plan strategy using defined benefit pension plan not in an entity taxed as a sole proprietorship;
   - Theoretically creates a better asset-protected entity with the ability to enjoy a reduction of potential Social Security and Medicare related payroll taxes (known as self-employment tax for sole proprietors) on income classifiable as corporate profits not related to clinical production (employee wages).
2. List of business-related deductions (not limited on the tax return if self-employed or if the physician owns the business):
   - Travel, 50% deduction of business meals and entertainment, possible depreciation expense on any vehicle with greater than 50% business use, vehicle travel miles (reimbursable by your company to you individually, which is particularly advantageous if the physician operates strictly out of a home office);

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- Potential home office deduction if no other office is available for your use;
- Cell phone used for business, continuing education, and other items not normally reimbursed by an employer.

3. Strategy to lessen overall tax burden via bifurcation of salary and corporate dividends/distributions:
   - This particular topic relating to PLLCs taxed as S corporations is very open to IRS interpretation with continual IRS scrutiny.
   - Salaries are subject to Social Security and Medicare taxation in addition to income taxes; dividends/S corporation distributions are not subject to those same payroll-related taxes.
   - Determination of the amount to pay in salaries compared to the amount that can be distributed from the PLLC/S corporation not subject to the payroll taxes is subject to much interpretation and must be considered on a case-by-case basis.
   - IRS states salaries must be reasonable, yet intentionally fails to define a reasonable amount, which leads to an intense amount of scrutiny regarding this tax issue. All research indicates the IRS will continue to "crack down" on abuses in this area of tax.
4. Other potential strategies to lower income taxes:
   - First, consider whether the goal is to lower taxes now (in potentially lower income-producing years) or later (in greater income-producing years assuming wealth accumulation).
   - What are the best after-tax investments based on your risk tolerance and understanding of wealth creation?
   - Are Roth accounts, conversion of traditional deferred tax accounts to Roth arrangements, and life insurance investing right for you as you focus your tax savings on the long-term savings strategies over your lifetime?
5. Viability of hiring family members to lower taxes:
   - Need to consider what potential taxes you are attempting to reduce. Is the concern income taxes or payroll taxes? Current reduction of income tax can be accomplished through additional deferral. However, if paying additional Social Security and Medicare tax is an issue, hiring additional family members may not be beneficial.
   - Please note: all family members must provide performance of service in order to receive compensation.

Asset Protection: Control Everything, Own Nothing

Asset protection is a key planning concept that is often overlooked. There are certain investment vehicles that provide automatic protection against creditors and litigation. Additionally, in some states, insurance company assets are also protected from these risks. A qualified financial planner can help identify these basic asset protection vehicles. Beyond these, however, we believe that it is critical to identify a professional whose sole purpose is to protect your assets.

One asset protection attorney, whom we consider a trusted colleague, has a simple yet powerful maxim, "*Own nothing. Control everything.*" Through a variety of simple to complex legal structures and strategies, this attorney works with his clients to provide assurance that their net wealth is protected. It just makes sense to dedicate some of your time and resources in addressing this serious issue. Asset protection can be broken down into several distinct arenas: professional liability, personal liability, family business structures, and estate planning.

Professional Liability

Disability Insurance

Our suggestion when evaluating disability insurance is to acquire true own occupation coverage. The definition of disability for doctors' insurance should read: "The inability to perform the material and substantial duties of your own occupation (recognized specialty)." This means that if you are unable to perform the functions required to earn your income in your chosen occupation, you are considered disabled, even if you are able to earn income in some other fashion. Many people we have met through the years have disability insurance contracts in place that include the definition above with an add-on stating, "so long as you are NOT working in any other capacity." The difference is considerable. Are you covered properly?

Relative to the amount of money you risk losing should you become disabled, the amount of premium you will pay to insure this loss with disability insurance is reasonable if not insignificant.

Disability insurance coverage can be used to address this risk. Some policy features to consider:

- Disability policies may be issued on an individual or group basis.
- Individual policies are also available through associations and professional organizations not available to the public.
- Benefit periods can vary from 24 months, 60 months, to age 65 or age 67. The longer period is recommended in most cases.
- "Noncancelable" and "guaranteed renewable" are important provisions to look for in a disability income policy. These provisions mean that the insurance company cannot raise your rates or discontinue your coverage as long as you continue to pay your premiums.
- Elimination or waiting periods typically range from 30 days to 1 year. This is the length of time you must wait until policy benefits are paid. Longer elimination periods result in lower premium cost.
- Cost of living adjustments protect against inflation.
- Future benefits based on income only (not medical) are highly beneficial.
- The definition of disability is covered later in more detail.

Medical Malpractice Insurance

Premiums for medical malpractice insurance vary greatly between specialties and states. The costs are prohibitive in certain state/specialty combinations, which has led to physicians using a self-insured strategy or "going bare" and relying on complex asset protection strategies. Regardless of your philosophy or practice environment, planning for medical malpractice claims is imperative. Virtually every physician will be sued at one point in their career, so proactive planning is essential.

Important considerations with medical malpractice insurance:

- Practicing in a state with solid tort reform measures will typically decrease premiums and frivolous suits
- Advocate for meaningful tort reform in your state
- Do not assume that your malpractice coverage will unilaterally protect you; your malpractice coverage may decline to pay the claim granted or your coverage may be exceeded
- You must have a personal asset protection strategy developed to protect against the possibility that litigation from your professional services may target personal assets

Mitigating Risk Through Common Sense and Good Behavior

Patients consistently cite poor communication and poor doctor–patient relationship as factors most likely to trigger a lawsuit. Thus, it should be noted that an important risk avoidance strategy is to simply be a nice person and try to effectively communicate with your patients. Even in the face of medical error, a physician who is well liked by the patient is less likely to face litigation.

Another important area of risk containment involves your partners. The specific structure of your professional services agreement can limit liabilities incurred by your partners through no fault or involvement of your own. Don't let your partners' drama become your economic and legal misfortune. Tales of partner infidelity and physician relationships with employees are numerous to the point of being cliché. If a partner had an extra-curricular relationship with an employee who subsequently had to be terminated, the potential for retaliatory litigation against the entire group is substantial. This is where indemnification clauses protect the individual physician from the actions of their partners. There are also several business models that can serve to insulate an individual physician from the professional or personal misdeeds of their partners.

Personal Liability

Physicians can become so consumed with the possibility of professional liability that they forget to protect against personal liability. Consider the many opportunities for personal liability: driving a car, owning a home or other property, owning a swimming pool, firearm, dog, or, even worse, your teenage child operating a car owned by you. Homeowners' insurance and auto insurance can provide some liability coverage in their specific arenas, but it may not be sufficient. There are 2 important strategies to managing your personal liability.

- "Umbrella" insurance policy: An umbrella insurance policy covers the insured in the event that they are subject to litigation. Distributions from the policy are used for both legal fees and to pay the claimant in the event that the insured is determined to be at fault. Policy values range from $1 million up to $10 million, with annual premiums as low as $200.
- Family attorney: It is prudent but not necessarily crucial to have a designated family attorney with whom you have an established relationship. The last thing you want during a legal crisis is to resort to a phone book to find an attorney who you do not know.

The final concept to master regarding both professional and personal liability is to understand the creditor's rights in your state. Creditor protection statutes vary widely from state to state.

The following assets may be protected from creditors:

- Primary residence: In Texas and Florida, a creditor who has won a claim against you cannot take your primary residence regardless of its value. In California, only $75,000 of the value of your home is protected.
- Qualified tuition payment plans (529s).
- Retirement accounts such as 401(k) and 403(b).
- Pension plans.
- Membership interest in an LLC is also usually protected although the extent to which it is protected depends on established case law in that state.
- Property owned by your spouse (unless you live in a community property state where husband and wife jointly own all marital income and assets: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin).

Family Business Structures

There are several strategies used to protect assets from both creditors arising from both personal and professional liability. The most commonly used are limited liability corporations (LLCs) and trusts. There is also a role for family limited partnerships (FLPs), but they are less desirable vehicles for asset protection. Equity stripping is another strategy to protect the value of your home or other real estate if you live in a state with minimal homestead protection laws.

Limited Liability Corporation

LLCs were officially recognized in the United States as a distinct business entity by a Wyoming congressional act in 1977. Since that time, it has been the subject of numerous state and federal legislative acts further establishing the specific rules and protections afforded to an LLC. It has become an attractive business model, particularly for small businesses because it offers excellent liability protection and pass-through taxation. Profits from an LLC are usually taxed as standard income to the members, referred to as pass-through taxation, which avoids self-employment taxation. The other attractive feature is the limitation of liability, as the name implies. Members of an LLC are not personally liable for the business, actions, or debts of the LLC except in some cases where members knowingly committed criminal acts through the LLC.

The LLC also possesses many features that lend itself well to asset protection. A properly drafted LLC offers the following asset protection features:

- Anonymity: Although penetrable, the LLC offers the members at least 1 step or degree of identity protection
- Nondisclosure: This provision prevents dissemination of company information to nonmembers
- Cannot assign interest: This provision states that a member's interest cannot be assigned to a creditor without the consent of all members not liable to the creditor
- Balance of power: This provision states that no single member can force distributions or liquidation of the LLC without consent of the other members
- Cease distributions: This provision states that the manager can cease distributions to a member pursued by a creditor
- Charging order as sole remedy: In states where a charging order is the only avenue by which a creditor can collect

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from a debtor's LLC, the charging order is used to obtain a lien on the distributions that would be made to the debtor. The creditor cannot obtain voting rights and cannot affect any business decisions.

As an example, if you are successfully sued for medical malpractice not covered by your malpractice insurance or some personal liability of $2 million, the plaintiff now becomes a creditor and you are the debtor who owes them. They can use any legal means necessary to collect the $2 million you now legally owe them. All of your personal assets and your family's assets would be discovered and recovered by the plaintiff up to the $2 million amount. In Texas, the creditor could not take your home, home furnishings, 2 of your cars, your wages, your 401(k), or your 529 plans. This would leave them searching for additional assets for compensation. Unprotected investment accounts, equity positions, and side businesses would be targeted.

If you owned a $5 million real estate company this would be an attractive option for the creditor. If that real estate business was a properly formed LLC in the correct state, the creditor would be left with a charging order as the sole remedy or method of obtaining compensation. The managing member could cease distributions to the debtor member indefinitely; the creditor could not force dissemination of company information, and could not seize control of the debtor member's interest in the company. This makes the LLC an unattractive option for the creditor as they may never collect in this manner.

Series LLC

A new concept that has been recognized in some states is the series LLC. The purpose of the series LLC is to eliminate the need to form multiple LLCs with similar business functions. Once again, a real estate business offers the clearest example of the benefits of a series LLC. Ownership of investment properties is a higher risk enterprise in terms of possible litigation. Some asset protection and legal advisors recommend placing each real estate property into a separate LLC so that a creditor arising from one property is not able to obtain control of all properties. There are multiple downsides to creating 26 LLCs for 26 separate properties. Each LLC has to file an income tax statement and a corporation tax statement in some states. The accounting may be more tedious and more expensive. A series LLC theoretically allows for formation of a single LLC with multiple self-contained compartments that are immune from liabilities created within another compartment. Instead of 26 LLCs and 26 tax IDs and tax filings, there would be 1 LLC with 26 compartments. If you are considering a series LLC, consult with multiple advisors familiar with the establishment and governance of this new entity. Because the series LLC is new, there is a paucity of case law to support or further define its limitations.

Family Limited Partnership

Similar to LLCs, FLPs can provide solid asset protection and minimize estate taxes when drafted properly by an attorney with specific provisions and bylaws that make the FLP an unattractive target for creditors. One of the biggest limitations of an FLP, unlike the LLC, is that the general managing partner is personally liable for the actions and business of the FLP. Therefore, an FLP would not be a good asset protection tool if it were used to run a high risk business like ownership of an apartment building.

Estate Planning

Wills and Testamentary Trusts

The first step in estate planning is the creation of a will, living will, and designated power of attorney in the untimely event of your death or incapacitation. Most physicians are familiar with these entities through our professional patient care experiences that demonstrate their importance. Rather than go into specific details regarding these entities, suffice to say that protecting your interests while you are still alive and coherent is always a better strategy than attempting to do so from the afterlife.

Testamentary trusts are trusts established by provisions within a will and are created at the death of the grantor. The trusts are always irrevocable and can address many issues from charitable giving to transmission of the estate with caveats. The alternative to a testamentary trust is a living trust, which is created while the grantor or creator is still alive.

Estate Tax Basics

Upon the death of an individual, their estate is determined to be the cumulative value of all property, investments, belongings, life insurance proceeds, and interests in jointly shared entities such as corporations or LLCs. Anything placed into a trust or given prior to death is not included in the estate. There are specific gift taxes and limitations in addition to the estate tax provisions. The estate tax exemption amount in 2013 will drop to $1 million and the maximum tax rate will increase from 35% to 55%. This means that all estates valued at over $1 million will be subject to taxation. In 2009, led by President Obama, democrats pushed for making estate tax exemption and rates permanent. Their proposal was for an exemption of $3.5 million and a top tax rate of 45%. The enormity of lost wealth due to estate tax is readily apparent, highlighting the importance of minimizing estate taxes during estate planning.

Basics of Trusts

There are many different types of trusts created with different goals in mind. A trust is a holding entity established/funded by the grantor or settler. There are many types of trusts offering different levels of asset protection, estate tax treatment, and control.

- Grantor (also termed the settler): The person(s) or entity who grants property or income to the trust.
- Beneficiary: The person(s) or entity who receives income, property, or utilization rights of that which has been granted to the trust by the grantor.
- Trustee: The person(s) or entity that holds legal title to the property of the trust, serves as the administrator of the trust, and acts in the interests of the beneficiary.

Benefits of a Trust

- Avoid the expense, public exposures, and delay of probate
- Afford protection from creditors

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- Minimize estate taxation
- Provide benefits for charity that can grow tax free
- Shift income to beneficiaries in lower taxation brackets
- Hopefully avoid intrafamily litigation over the contents of the estate

Common Trusts

Revocable Living Trust

A revocable living trust is set up by the grantor or settler with the grantor as the beneficiary. Also termed self-settled trusts, this prevents an estate from going to probate and can establish provisions in the event that the grantor is incapacitated. Properties can be moved in and out of the trust by the grantor and control of the trust remains with the grantor. The self-settled trust does not provide protection from creditors and should not be used as a stand-alone asset protection strategy.

Irrevocable Trust

In contrast to revocable living trusts, the grantor gives up control of the assets within an irrevocable trust. Although the grantor may place stipulations on the distribution of assets from the trust based on age, marriage, or college graduation of the beneficiary, the grantor gives all control of the trust to the trustee.

Irrevocable Life Insurance Trust

Without the establishment of an irrevocable life insurance trust, the proceeds from a life insurance policy will become part of the deceased's estate and thus exposed to estate taxation depending on the total amount of the estate and current laws. Wealthy individuals with large estates can deed their life insurance policy to an irrevocable life insurance trust. The trust becomes both the policy holder and beneficiary of the policy on the death of the grantor; however, the grantor's heirs remain the beneficiaries of the trust. This exempts the proceeds from the estate of both the deceased and the spouse of the deceased. When planning to use an irrevocable life insurance trust as part of your estate management, it is important to be proactive because the grantor must live for 3 years after deeding the life insurance policy to the trust to be valid.

Domestic and Foreign Asset Protection Trusts

Also termed self-settled spend-thrift trusts, these trusts are used primarily to shield assets from creditors. There has been increasing federal scrutiny regarding these entities, particularly the Foreign Asset Protection Trusts. The trusts are always irrevocable in order to satisfy the asset protection aspects of the trust. Some individuals used the Foreign Asset Protection Trusts as investment entities to avoid paying income or capital gains taxes. Utilization of a trust to avoid paying capital gains or income tax is not a legal or sound strategy.

Charitable Trust

Donations to a charitable trust may be tax deductible if the trust is correctly designed with a charitable beneficiary or beneficiaries. The funds within the charitable trust may also be allowed to grow without incurring taxes.

List of common trusts:

- A/B trusts
- Asset protection trusts
- Bypass trusts
- Credit shelter trusts
- Charitable trusts
- Charitable split-interest trusts
- Charitable lead trusts
- Charitable remainder trusts
- Charitable remainder annuity trust
- Charitable remainder unitrusts
- Charitable remainder unitrusts with net income make-up provisions
- Complex trusts
- Constructive trusts
- Crummey trusts
- Dynasty trusts
- Generation skipping trusts
- Grantor trusts
- Grantor retained income trusts
- Life insurance trusts
- Qualified personal residence trusts
- Qualified terminable interest property trusts
- Resulting trusts
- Revocable trusts
- Simple trusts
- Special needs trusts
- Spendthrift trusts
- Testamentary trusts
- Totten trust

SUMMARY

Protecting everything you have worked for requires planning, patience, and a moderate dose of paranoia that everyone may be out to get you, because may be they are! Scrupulous budgeting, balanced wealth management, and estate planning are all vital to protecting and building your wealth for you and future generations. Effective estate planning requires a multifaceted proactive approach to minimizing estate taxation, avoiding probate, providing a smooth transition of assets to heirs, stipulating important end of life care issues, and protecting assets from creditors. The complexity of estate planning laws, vehicles, and considerations warrants the addition of a skilled estate planning attorney to your team of financial advisors.

Disclaimer: The authors of this article are not CPAs or attorneys NOR are paid a fee for tax or legal advice. You should consult with your local professional prior to making any decisions.

SUGGESTED READING

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