How Much Are You Leaving on the Table?

How to improve your after-tax financial efficiency for 2014.

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Most dermatologists strive to achieve two goals in their practice—to “do good,” by being a quality practitioner and helping patients, and to “do well,” in terms of financial rewards.

Unfortunately, as to the second goal, many do not operate their practices with optimal after-tax efficiency. In fact, we often see doctors leaving tens of thousands of dollars “on the table” each year—which can equate to nearly $1 million of lost wealth over a career. The good news is that many of you reading this can likely improve your post-tax bottom line in a number of ways.

Early in the Year is "the" Time to Make Changes

We have found that most physicians, including dermatologists, typically get motivated to make changes to reduce taxes and improve financial efficiency at two times—around April 15th when they experience the pain of the tax payment (even if their return is on extension) or late in the calendar year, as they finally see what their income will be for the year and dread the upcoming April 15th payday. In fact, focusing on improving your after-tax bottom line and reducing funds “left on the table” should really be done early in the year—in the first calendar quarter certainly.

Changes made early in the year can benefit the practice/physician for 10, 11, or even 12 months of the year. This can make it easier on cash flow (i.e., funding a benefit plan evenly every month or quarter vs. finding the cash to make a large annual payment in December) and even have a better tax impact earlier in the year (i.e., reducing quarterly payments throughout the year). For these reasons, we encourage you to consider these changes early in 2014 and get motivated to impact your bottom line today.

The Common Causes of Dollars “Left on the Table”

While the causes of “dollars left on the table” in a dermatology practice can range from billing errors to unproductive employees, our expertise and focus is corporate structure, tax reduction, and benefit planning, so this article will focus on three strategies for recapturing some of the funds left on the table:

1. Using the ideal corporate structure
2. Maximizing tax-deductible benefits for the physician-owner(s)
3. Utilizing a captive insurance arrangement

The most important thing you can do is keep an open mind. Just because you have operated your practice a certain way for the last 5, 10, or even 20 years, doesn’t mean you have to keep doing the same thing. Changing just a few areas of your practice could recover $10,000-100,000 of “lost dollars” annually. Let’s explore the three areas.

1. Using the Ideal Corporate Structure

Choosing the form and structure of one’s practice is an important decision that can have a direct impact on your financial efficiency and on the state and federal taxes you will owe. Yet from our experiences in examining more than 1,000 medical practices of our clients, including many dermatology practices, most physicians get it wrong. Here are a few ideas to consider when thinking about your present corporate structure.

Avoid using a partnership, proprietorship, or “disregarded” entity. These entities are asset protection nightmares and can be tax traps for dermatologists. Nonetheless, we have seen very successful doctors operating their practices as such. The good news is that doctors who run their practices as a partnership, proprietorship, or disregarded entity have a tremendous opportunity to find “dollars on the table” through lower taxes—especially on the 3.8% Medicare tax on income.
This can be a $10,000 to $30,000 annual recovery. If You Use an “S” Corporation, Don’t Treat it Like a “C” Corporation. We estimate that 60–70 percent of all medical practices are “S” corporations. Unfortunately, many physicians do not take advantage of their “S” corporation status—using inefficient compensation structures that completely erase the tax benefits of having the “S” in the first place. If your practice is an “S” corporation, you should maximize your Medicare tax savings through your compensation system in a reasonable way. This can be a $10,000-30,000 annual recovery for practices not properly structured.

Implement a “C” Corporation. Once upon a time, “C” corporations were the most popular entity for US medical practices. Today, fewer than 15% of medical practices operate as “C” corporations. Why? We believe it is because most physicians, bookkeepers, and accountants focus on avoiding the corporate and individual “double tax” problem.

While this is crucial to the proper use of a “C” corporation, it is only one of a number of important considerations a physician must make when choosing the proper entity. A common mistake is to overlook the tax-deductible benefit plans that are only available to “C” corporations. If you have not recently examined the potential tax benefits you would receive by converting your practice to a “C” corporation, we recommend that you do so. Utilizing benefit plans that only a “C” corporation can offer can create a $10,000-30,000 annual improvement.

Get the Best of Both Worlds – Use Multiple Entities. Very few dermatology practices use more than one entity for the operation of the practice... and, if they do, it is simply to own the practice real estate. While this tactic is also wise from an asset-protection perspective, its tax benefits are typically non-existent.

Successful practices can often benefit from a superior practice structure that includes both an “S” and a “C” corporation. This can create both tax reduction and asset protection advantages. If you have not explored the benefits of using both an “S” and “C” corporation to get the best of both worlds in planning, now is the time to do so. Utilizing a two-entity structure properly can create a $10,000-40,000 annual improvement.

2. MAXIMIZING TAX-DEDUCTIBLE BENEFITS FOR THE DOCTORS IN THE PRACTICE

If you are serious about capturing “dollars left on the table,” tax efficient benefit planning must be a focus. Benefit planning can definitely help you reduce taxes, but that is not enough. Benefit plans that deliver a disproportionate amount of the benefits to employees can be deductible to the practice, but too costly for the practice-owners. These plans can be considered inefficient. To create an efficient benefit plan, physicians need to combine qualified retirement plans (QRPs), non-qualified plans and “hybrid plans.”

Nearly 95% of the physicians who have contacted us over the years have some type of QRP in place. These include 401(k)’s, profit-sharing plans, money purchase plans, defined benefit plans, 403(b)’s, SEP or SIMPLE IRAs, and other variations. This is positive, as contributions to these plans are typically 100 percent tax deductible and the funds in these plans are afforded excellent asset protection. However, there are two problems with this approach—many QRPs are outdated and QRPs are only one piece of puzzle.

First, most physicians have not examined their QRPs in the last few years. The Pension Protection Act improved the QRP options for many doctors. In other words, many of you may be using an “outdated” plan and forgoing further contributions and deductions allowed under the most recent rule changes. By maximizing your QRP under the new rules, you could increase your deductions for 2014 by tens of thousands of dollars annually, depending on your current plan.

Second, the vast majority of dermatologists begin and end their retirement planning with QRPs. Most have not analyzed, let alone implemented, any other type of benefit plan. Have you explored fringe benefit plans, non-qualified plans or “hybrid plans” recently? The unfortunate truth for many physicians is that they are unaware of plans that enjoy favorable short-term and long-term tax treatment. These can have annual tax advantages that vary widely ($0-50,000) and also have varying degrees of long term tax value as well. If you have not analyzed all your deductions for 2014 by tens of thousands of dollars annually, depending on your current plan.

3. UTILIZING CAPTIVE INSURANCE ARRANGEMENTS

For practices with gross revenues greater than $3 million, a small captive insurance arrangement might be significant way to recapture “dollars left on the table.” Today, there are likely many risks in your practice that are going uninsured—from excess malpractice, economic risks, employee risks, and litigation defense risks from any number of audit or fraud claims. Like most physicians, you likely just save funds personally and hope that these risks don’t come to fruition. As a result of your de facto “self-insurance,” you are not taking advantage of the risk management, profit enhancing, and tax reduction benefits that are available to you with a captive.

By creating your own captive insurance company (CIC), you can essentially create a pretax war chest to manage such risks. If structured properly, the CIC enjoys tremendous risk management, tax, and asset protection benefits. The potential tax efficiency, in fact, can be in the hundreds of thousands of dollars annually. While an experienced law firm, captive management firm, and asset management firm are crucial, you as the captive owner can maintain control of the CIC throughout its life. It can then become a powerful wealth creation tool for your retirement.
CONCLUSION

Nearly everyone of you reading this article would like to be more tax efficient. We hope that these ideas motivate you to make tax and efficiency planning a priority, so you too can recapture the “dollars left on the table.” If you can focus some time and effort on this in early 2014, you will be glad that you did. We welcome your questions.

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