How to Conduct At-Home Financial Tests — Part 1

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You were taught much of the science that goes behind making good medical decisions for your patients. You also know the best form of preventative medicine is adopting and maintaining a healthy lifestyle. Small things that are caught early could lead to greater life expectancy, while large things that are caused by years of bad habits and misdiagnoses lead to poor outcomes. This article takes a scientific approach to how you can conduct a thorough review of your personal finances in the same way that at-home health tests help to gauge personal health. Ultimately, much like an annual check-up, it is best to work with a competent professional to work out proper prescriptions and treatments. However, this guide will serve to help you detect early signs of financial distress while giving generally helpful advice on how to mitigate the symptoms and effects. Given the expansiveness of this topic, this will be part one of a multi-part series to conduct these at-home financial tests.

KEY WORDS: DIY financials; financial literacy; financial education.

This article is intended as a roadmap for high-income individuals — especially those in medicine — who want to better grasp their personal finances. While we use financial planning software, many people achieve similar results using open-source software or customized spreadsheets. We highly recommend using one of these tools for at-home financial tests.

Much harm comes from relying on a "gut feeling" that is often false unless examined under the microscope of math. If you are unfamiliar with financial software, you may want to work with a financial professional. It should be clear which of the following self-audit steps you can complete without a tool or special software. In other cases, the information here may simply help you evaluate where a professional can help you most.

EMPLOYEE BENEFITS/ CONTRACT REVIEW

Whether you are a 1099 contractor or a W2 employee, you should have employee benefits. Regardless of your pay structure, there are decisions to make when it comes to employee benefits. Why is this area so important? This area is the foundation on which you build your financial framework when building wealth.

Given the group nature of these benefits, large employers often negotiate lower costs versus what is available to private individuals. Employee benefits also often come with lots of tax advantages for you and your employer.

If you are fortunate enough to be your own employer, you benefit from both sides of this tax advantage coin. If you have no benefits, you are doubly punished through tax inefficiency and lack of structured benefits. We will break this down into W2 versus 1099 and what to look for.

W2 Income (May have additional income on the side)

When performing this at-home test, we highly recommend using a spreadsheet or financial tool. This test will involve comparing what you currently have versus what your employer offers you versus what your (former) employer had available. We will start with the tests that you can perform without financial planning tools/software:

1. **Review your employment contract**. Focus on the description of your compensation. For example, here are two types of compensation structures with the same overall income of $300,000:

Employee A:

- $100,000 Salary/Covered Compensation
- $100,000 Negotiated Pay
- $100,000 Performance RVUs

Employee B:

- $300,000 Salary/Covered Compensation

Both employees earn $300,000; however, benefits tied to "salary" or "covered compensation" revolve around the first line item. For example, if your employer offers you group life insurance coverage of 1x salary, in the first case, it would be

a $100,000 death benefit. The second offer would pay the full $300,000.

2. **Evaluate the "buy-ups"/voluntary benefits**. This section is better served with a planning tool but may not require it if you have sufficient knowledge of your personal finances.

For example, if you know you need to fill a prescription to the tune of $100 a month, you can contribute $100 into a flexible savings account (FSA) (if provided), which will save you from paying taxes on the contribution while allowing you to use that amount to pay for the prescription. This amounts to anywhere from 32% to 37% in federal tax savings for high-income households. For other "buy-ups," such as life insurance/disability insurance/health savings accounts (HSAs), you would want to use a tool to compare the relative costs versus the benefits before opting in.

Remember that these benefits are paid for "out of sight and out of mind." However, if you choose to "opt-out," you might beef up each paycheck by $1 to $1,000+. This often adds up to a "silly goose" tax of $10,000+ for those who "opt-in" to every benefit whenever they change employers without reading through each individual benefit.

However, if you choose to elect no voluntary benefits each time, you run the risk of overpaying on the open marketplace, leaving money on the table. Each benefit should be weighed against your personal financial picture.

1099 Income (and K-1 Income)

Here, you are both employer and employee. When you are performing this at-home test, we highly recommend using a specialized tool. We also often recommend that you consult with a tax professional who is familiar with the relevant tax laws of your state.

1. **Consider your employee benefits from your last job or an alternative "corporate job" in a similar line of medicine**. When a third party funds those benefits, it can pay to take everything you can get. But when you are both an employer and an employee, you truly have the flexibility to be creative.

For example, if you are early in your career, you're likely eligible for low-cost underwriting for life, health, and disability insurance. That benefit is not as valuable as the employer contributions to your retirement plan or the access to an HSA plan. Alternatively, if you are older, you look at the relative difficulty of acquiring disability, life, and health insurance and may highly value employer-provided insurance. Once you identify the benefits you valued most from your previous employer, you can re-create the benefits you like and eliminate the items you never used.

Note: Employee benefits purchased for a small or solo practice will have pricing similar to that of the open marketplace. As you develop your business, you may start to access more competitive pricing. Once you have at least 10 employees, it may be time to consider consulting with a benefits broker.

2. **Consider your entity carefully**. We have spoken with hundreds of medical professionals who opened an LLC, S Corp, or C Corp because they "read somewhere that…." or "know a friend who…" or "it helps me save on taxes." Know that not everyone has the same health goals and lifestyle needs, and not everyone has the same financial goals and financial lifestyle needs.

If you do not treat your business entity as a business, the IRS will probably not treat your business entity as a business in the event of an audit. Be honest with yourself about what you are trying to accomplish before setting up any entity. Here are some reasons why you may want to set up an entity:

- You are in an area of medicine where you can take advantage of lowering your "reasonable salary" to mitigate the Old-Age, Survivors, and Disability Insurance contributions. This is the "social security tax."
- The medicine you practice can potentially cause litigation. The entity can create some legal separation between you and the medicine you practice.
- There are minimal time and financial costs for establishing your entity in the state where you choose to establish your entity.
- You have credible tax mitigation strategies you want to pursue that cannot be done under a sole proprietorship model.

3. **Consider why you are "in business."** If the reason is to make as much money as possible and invest outside of that business (i.e., retirement plans, rental properties, private investments, etc.), you should build employee benefits that are focused on how to extract as much long-term value as possible. This will mean most, if not all, of your employee benefits will be extractive in nature. Cash balance pension plans, profit-sharing 401(k)s, and all sorts of K-1 distributions to yourself will be the types of strategies that you will explore.

However, if you plan to pass down your business to children or build your business for acquisition, there are many other tax and legal considerations. Remember that if you build your business to go to your kids, your employees will either resent this or understand that you consider them part of the vision. There are always carrot-and-stick measures that you can create using employee benefits to retain these top talents, similar to what Fortune 500 companies employ. This projection work requires dedicated tools and credible consultants to design and implement.

HEALTH INSURANCE

The total cost of health insurance is often miscalculated when reviewing benefits. You must look at the total after-tax cost to compare and value health insurance plans. This means you need to look at more than just the amount withdrawn from your paycheck to cover your portion of the insurance premium.

For example, it might save a physician in a high tax bracket more money to elect a high-deductible health plan while contributing to an HSA, or it could save more money

to elect a higher premium health plan that also comes with an employer contribution to an FSA. You really won't know until you run the numbers for your specific tax bracket and insurance plan details.

Calculate the total annual cost of a health plan for comparison:

Premium cost per pay period (multiply by # of pay periods per year)
+ Anticipated expenses (this is your likely total out-of-pocket cost)
– Tax savings on premiums (multiply the premium cost by your marginal tax rate)
– Tax savings from HSA contribution
– Employer HSA or FSA contributions

= Net after-tax cost to you

For anticipated expenses, assume you have a year of high health expenses and a year of low health expenses for each plan. Total what each would cost you in the form of a deductible, co-pays, and estimated co-insurance amounts for comparison.

The after-tax cost of your health insurance has a meaningful impact on your cash flow. Once you've crunched the numbers for each plan, you'll be in a much stronger position to properly compare your choices.

TAXES (AND HOW TO PROPERLY PAY THEM)

Whether you are a 1099 contractor or a W2 employee, don't leave the IRS a tip. Here are the general guidelines for performing at-home financial tests on your 1040. We recommend hiring a competent tax professional to file your taxes if they are complex. However, having a tax mitigation professional review ideas may be even more invaluable.

1. **Should you fire your CPA over your 1040?** We often ask clients: "What is a CPA's job?" The answer is typically, "To save me money on taxes." That is the wrong answer. The right answer is, "To make sure I am not audited for tax issues."

One way to make sure you are not audited is not to try any creative tax mitigation strategies. In reviewing your 1040, check your tax deductions for the past two years. If you have only taken the standard deduction and have not itemized deductions, you have your first "green flag" for firing your CPA. You can file for a standard deduction yourself, so why bother having someone file the standard deduction for you and your family?

2. **Are you paying too much in taxes?** Imagine your income is like a delicious slice of cake that a hungry government is trying to eat. The top layer of that cake is filled with light, fluffy icing (the cream), while the bottom layer is a rich cake. Because the top layer is so light, it is easier to eat. Your top layer is where your income is taxed in the 30% range; the rest of your income is taxed around 10%–25%. Try to minimize that top layer of the cake. You can mitigate this with deferrals and credits. Hiring someone to go over "cream mitigation strategies" will be helpful.

3. **Lifetime tax modeling is a lifesaver.** You know what you are paying in taxes now; you do not know what you will pay in the future. However, using financial modeling can give you an idea of when to take income, when to defer income, and when you should try to mitigate future taxes by contributing after-tax income into various wealth creation strategies.

Whether you are trying to create a real estate empire, private equity portfolio, or another strategy, think about your cumulative tax decisions in terms of your lifetime tax bill. Ignore individual products that "save taxes" on a one-time basis. Once you understand the lifetime impact, you will better understand whether a strategy "saves taxes."

Consider rental properties, for example.

- The cost of acquisition is generally 6% of your after-tax wealth, and the cost of disposal is 6% of the sales price. Anyone trying to tell you that "only one side" pays the costs is trying to sell you a rental property.
- Maintenance costs are after-tax income that goes toward fixing a house, estimated at about 1% of the total cost of the property each year.
- Property taxes are after-tax income that can be calculated as an annual percentage that increases with a certain percentage of inflation but is deducted up to the state and local tax (SALT) limitations.
- Insurance costs are tax income that can be calculated by the current cost plus the appreciation rate of your home.

This is the minimum we need to determine the tax consequences of holding this asset before factoring in any long-term wealth creation from it.

FINAL WORD

These topics are only the start of what you can do via at-home financial testing. However, doing these few tests will be helpful in preventing many of the missteps highly compensated medical professionals take. Due diligence pays lifetime returns. We hope you return for our next installment!

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