Let's talk

What's the Rx? Retirement and tax strategies for hospital-based physicians

Physicians today are facing many challenges related to their profession. One of the primary challenges is complying with the many changes mandated under the Affordable Care Act (ACA), which include complying with modifications to the Medicare reimbursement system and adopting procedures related to electronic medical records.

Along with the challenges related to their businesses, physicians also face a number of personal financial and tax planning challenges with the recent passage of the American Tax Payer Relief Act of 2012 ("ATRA"). Although this legislation has provided some certainty and clarity related to income tax and estate tax concerns, it has increased the need for planning and advice for those who will see their tax rates rise.

Key takeaways:

- Physicians face many challenges today related to their profession – some that impact their business and some that affect their personal financial and tax planning.
- Physicians should take full advantage of the employer-sponsored retirement plans available to them.
- Physicians should use a comprehensive approach to financial and tax planning, linking employer-sponsored retirement benefits with individual planning considerations and investment allocation decisions.

Types of retirement plans

Physicians employed by a hospital, hospital-based system or health maintenance organization typically have retirement plan options in place as part of their overall employee benefit package. Physicians should make sure that they have an understanding of their benefits and are taking full advantage of the employer-sponsored retirement plan options available to them. Two main types of qualified retirement plans are defined contribution plans and defined benefit plans. A defined contribution plan allows physicians to defer wages into the plan and may also include employer matching contributions. Defined benefit plans are funded by the employer on behalf of the physician and are designed to generate a specified benefit to the physician in retirement.

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In a nonprofit hospital setting, the most common type of employer-sponsored defined contribution plan is the 403(b) plan. A 403(b) plan operates in a very similar manner to its corporate for profit cousin the 401(k) plan. Physicians should contribute the maximum allowable to this plan (2013 annual limits: $17,500 + $5,500 catch up contribution if over age 50). Some employers may also have a 457(b) plan available. This allows a physician to make additional salary deferrals and further fund their retirement. The contribution limits are identical to the 403(b) (catch-up contributions for ages 50+ may or may not be available), effectively allowing physicians to double the annual amount that they are sheltering from current taxation.

If both 403(b) and 457(b) plans are available, maxing out each plan would allow a physician to make total pre-tax contributions of $35,000 (additional amounts apply if over age 50), which reduces a doctor's federal tax bite by $13,860 if in the top marginal tax bracket (39.6%). If a physician operates as an independent contractor or receives other income outside of the hospital setting, additional self-employed retirement plan options are available to further reduce current taxable income.

A comprehensive approach

Physicians should approach wealth management and planning as a coordinated overall strategy, linking employer-sponsored retirement benefits with individual planning considerations and investment allocation decisions. Based on the physician's situation, tax conscious financial planning strategies could include some of the following:

Roth IRA's – For early career physicians, if modified adjusted gross income in 2013 is below $127,000 (individual) or $188,000 (married filing jointly), a Roth IRA could be funded up to the annual maximum of $5,500 ($5,000 for 2012). If married and filing a joint return, a Roth IRA could also be established for a spouse if income is below the same thresholds. Although Roth IRAs do not provide an immediate tax benefit, they can be a powerful wealth accumulation tool because earnings accumulate tax free and distributions are free of tax in retirement.

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Cash Value Life Insurance – Life insurance can be another way for physicians to diversify their retirement income. Cash value policies can be tapped into during retirement with tax-free withdrawals of premium payments and loans on any appreciation. A variable policy could be considered to allow for an appropriate allocation towards equities, increasing the potential for growth. Group plans could be available through the employer. An insurance analysis should be conducted, evaluating and comparing group and individual policies.

Asset Selection and Location – As part of the Affordable Care Act, a new 3.8% Medicare surtax applies to investment income when modified adjusted gross income exceeds $200,000 (individuals) or $250,000 (married filing jointly). Increased tax rates on capital gains and dividends also apply to wage earners in the top marginal tax bracket. With these two tax hikes combined, investment-related income for physicians in the top tax bracket can be as high as 23.8%. To combat this, physicians should implement a comprehensive portfolio management strategy. Income-producing assets, such as bonds, dividend-yielding stocks and REITs, should be allocated to tax-sheltered retirement accounts. Equity allocations should be skewed towards taxable accounts. Due to their tax-free nature, municipal bonds should also be considered as a fixed income investment option inside of taxable accounts.

Non-Deductible Traditional IRA – Most physicians will exceed the income thresholds for Roth IRA eligibility, but all hope is not lost for taking advantage of additional retirement strategies. Physicians and spouses can fund Traditional IRA accounts up to the same annual limits as indicated above for Roth IRAs. In most cases, an immediate tax deduction will not be available, but making Traditional IRA contributions can provide a means for managing the impact of the 3.8% Medicare surtax. As part of a comprehensive asset allocation and asset location plan, income-generating securities can be purchased with annual IRA contributions. These assets would be sheltered from current income tax and the Medicare surtax, and the account would enjoy the benefits of tax-deferred growth. When assets are disbursed in retirement, the growth portion is taxed at ordinary income rates, but direct exposure to the additional 3.8% Medicare surtax is avoided.

Timing of Deductions – The phase-out limits related to itemized deductions are back as part the recent legislation. If adjusted gross income exceeds $250,000 (individual) or $300,000 (married filing jointly), itemized deductions begin to be reduced. Physicians should be mindful of these limits when considering deductible expenses, such as real estate tax payments, year-end mortgage payments and charitable contributions. Careful analysis should be done when considering whether to lump these deductions together in one year versus allocating them over a few years with the phase-out thresholds in mind.

Consider a gifting strategy – If a physician accumulates excess wealth, gifting income-producing assets and appreciated securities can help keep current income taxes down and push the tax burden to lower income beneficiaries, ultimately resulting in less tax on total wealth. A gifting strategy can also help reduce estate taxes when a taxable estate exists.

A coordinated, comprehensive strategy of understanding and maximizing employer-sponsored retirement benefits, along with an appropriate dosage of individual strategies, can lead to good "financial health" for hospital-based physicians. An experienced Key Private Bank team can help guide the way and outline a plan "fit" for long-term financial success.

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