Profits: Plow Back or a Separate Nest-Egg?

It depends, but proper planning and goal-setting is the key.

BY JAMES D. KRICKETT

Many podiatrists have a substantial portion or, all-too-often, virtually all of their net worth tied up in their practices. Over the years, many have re-invested their earnings in the practice. Frequently, they've added to the asset concentration by owning the building or other assets used by the podiatry practice.

Obviously, the older the podiatrist, the more important investment assets become. But should those funds be re-invested in the practice or should you, the principal in the practice, begin thinking about putting those funds elsewhere, perhaps into a nest-egg for retirement? Or, perhaps use those funds to generate a completely new income stream?

Investing In the Practice

If you are at all like many other professionals, particularly those with young, growing practices, you have a large portion of your personal assets invested in that practice. For some, this may be necessary in order to ensure the continued survival and growth of the operation. Other podiatrists, however, are faced with the question of whether to plow the profits back into the practice, or whether it might be more advisable to establish a separate nest-egg.

Many podiatrists take as much from their practices as they can through distributions. For those operating as S corporations, partnerships, or limited liability companies (LLCs), these distributions are often in form of loan repayments and usually not taxable. Those distributions can, of course, frequently have negative consequences. Having equity capital can, for example, be an important consideration in whether a podiatry practice will get a loan or whether a supplier will extend credit on favorable terms, etc.

There are also tax reasons for retaining funds in the podiatry practice. A high debt-to-equity ratio can indicate to an IRS auditor that loans made by a podiatrist to his or her practice are really equity investments (regardless of how they are accounted for or documented). Nor can a practice shareholder/officer's low salary be challenged if distributions are taken from an S corporation.

Finally, if the practice principal/shareholder has an insufficient amount invested, (the "basis," in the podiatry practice), any losses from the operation may not be immediately recognized for tax purposes.

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Profitable Practices as an Investment Vehicle

Have you examined your practice as an investment vehicle as opposed to that practice serving as a job-replacement gadget or a much-needed service to patients? Examining the practice as an investment vehicle can provide another vantage point from which to evaluate and fine-tune the operation—as well as helping decide where extra savings or practice profits would produce the best return.

No salary, or a low one, for practice principals can be challenged if the podiatrist takes distributions from the practice operating as an S corporation. With insufficient basis in the practice, the principal may not be able to take current losses.

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Becoming the Practice's Landlord

Many podiatrists already own or have given a great deal of thought to owning the building housing the podiatry practice and collecting rent. More than likely, the rental income from the property will be or already is considered to be so-called "non-passive" income and can't be used to offset passive losses from other rental properties the podiatrist might own.

In one recent Tax Court case, *Stephen P. Hardy et ux.* (*T.C. Memo.* 2017-16), the taxpayer was a limited partner in a surgery center in which he performed surgery (he also performed surgery at other facilities as well). He had no day-to-day management responsibilities with respect to the property.

According to the Court records, the net income from the facility was used to offset passive activity losses. Not too surprisingly, the IRS argued the taxpayer's activity as a surgeon should be grouped with his activity at the property. In addition, the IRS argued that the taxpayer was liable for the self-employment tax on his income from the partnership.

The Court, however, ruled that the IRS could not regroup his activities into a single unit because there was more than one reasonable method for grouping his activities and the taxpayer's grouping did not have the principal purpose of circumventing the underlying policies of the Section 469, Passive Activities regulations. What's more, the taxpayer received distributions from the partnership as a limited partner acting in his capacity as an investor.

Growing Future Nest Egg Profits

It comes as no surprise that small businesses are a growing industry. U.S. government statistics show that about two thirds of the country's economic growth in the last decade has occurred in the small business sector. In fact, a successful small podiatry practice may be the most profitable investment you can make.

As mentioned, however, podiatrists often desire income from a source or sources outside the practice. A second source of income, be it dividend and interest income generated by a nest egg, other investment income, or even income from another practice or business, is best compared to a "safety net" under the day-to-day operation of the podiatry practice. Thus, it is important to choose how and where to invest. Re-investment in the practice might help ensure its success. Or, would it be better to make investments to provide what may be a much-needed safety net?

How Much Re-investment?

While many advisors suggest re-investing as much as fifty percent of the profits back into the practice, this seems a bit higher than the third of the profits many studies show are re-invested. Instead of using some arbitrary figure, podiatrists should consider the personal goals for the practice. Is that goal a mega-facility empire or merely a practice generating enough to live on comfortably?

There's nothing wrong with wanting to work less and growing the practice to a certain point sufficient to pay the bills, but a more modest approach to spending and saving might work. And don't forget about the tax benefits of putting money back into the practice. Any money re-invested is considered a business expense and income taxes won't have to be paid on it.

A successful financial investment plan should offer a choice between allocating profits back into the practice, or into a more diversified portfolio.

Building a Basic Nest Egg

Many professionals fail to build a nest egg of any kind. Fortunately, it is easy for anyone to put money away for the future. For example, when building that nest egg think about the following:

• Pay yourself first: As mentioned, many podiatrists usually want to re-invest in their practice. While this is great, it is also necessary to know how to save money. To get started, open a savings account. While it might appear futile with today's low interest rates, savings quickly add up.

• Understand the options: A podiatrist has many retirement savings options. With the help of a qualified advisor, anyone can find the most beneficial money-saving vehicle. Keep in mind the necessity of utilizing all available resources when building a nest egg.

• Save like crazy: Every podiatry practice has good and bad years. In a good year, lots of cash should be put away. Saving during good times helps a practice weather the inevitable bad times.

Saving money should be a priority for every podiatry professional. Luckily, there are a number of resources for saving. Since many podiatrists often have an unreliable income, it is crucial to begin planning as soon as possible. For most of us, this means investment planning.

Investment Planning

Investment planning involves finding the best type of investment for the income generated by the podiatry practice. Naturally, the type of investment vehicle decided on will vary depending upon the lifestyle desired by the investor, his or her temperament, the goals being targeted, and the time-frame available to achieve those goals. The investment planning process doesn't in any way require you to pull back from the podiatry practice at any time; it does suggest that you should build the capability to do so, should it become necessary or if you ever desire.

A diversified investment portfolio embodies that old saw that warns against putting all of our eggs in one basket. By having several kinds of investments, such as stocks, bonds (both general and corporate), real estate and, perhaps, precious metals, you greatly reduce the chance that a particular economic or legal change will devastate your investment fund.

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ment plan should offer a choice between allocating profits back into the practice, or into a more diversified portfolio. In other words, your financial plan should do for you the same thing that your practice does: increase your personal wealth.

Over time, this financial planning process should enable you to rely less on earned income (that is, the income that you derive from your podiatry practice and more from unearned income ("outside" investments, such as stocks and bonds).

Most financial plans involve five steps:

1) Identify what you already have. The first step with investment or financial planning is to create a personal inventory of your wealth, income, and expenses as well as any existing planning documents such as insurance policies, wills, and the like. Obviously, you must know where you are financially before you can decide on future goals and the steps necessary to achieve them.

2) Decide what you want. Next, a podiatrist must set his or her goals and quantify them in terms of dollar amounts and the time that you have left to achieve them. Admittedly, establishing a dollar figure for the amounts needed in order to maintain your present lifestyle for a number of years down the road can be a complex process involving inflation and future value. Keep it simple by thinking in today's dollar value.

3) Determine how to reach those goals. This is the heart of the financial plan. You must figure out what should be done to achieve your goals, or adjust them so that they become attainable.

A fifty-five-year old podiatrist establishing a financial plan to enable him or her to retire in 10 years can't achieve financial security or any desired lifestyle by placing savings in today's low-yielding savings accounts. Similarly, although risk is generally equated with return, few podiatry professionals would risk their investments with stock in start-up or risky fast-growth companies.

4) Implement the plan. This may be the most important step. After all, many may think about it, but few plan, and even fewer actually implement a financial or investment plan.

Having a plan in place will also help when it comes time to sell the practice since it provides a podiatrist with more flexibility when structuring the sale.

5) Maintain your plan. Even the best financial plan can sour with age. You need to keep your plan up-to-date by making sure that your investments perform as expected as well as by adjusting your financial plan for changed circumstances.

Properly handled, the investment planning process should not in any way require you to retire or pull back from your podiatry practice at any time. However, properly handled investment planning does suggest that you should build the capability to do so, if you ever so desire.

Playing Catch-Up

Those who have not been socking money away might want to consider a defined-benefit retirement plan, essentially a podiatrist's own pension plan. These plans work well for high-income professionals and business owners in their fifties who have less than they should in retirement savings and want to contribute more than defined-contribution plans (such as a 401k) allow. Big contributions are essential for those who don't have a lot of time for the account to grow. And, best of all, contributions are also tax-deductible.

Setting up a defined-benefit retirement plan can be expensive, since it requires an actuary to determine your contribution limit. It's best for professionals and business owners who are at least five years away from retirement in order to allow more time to save.

Having a plan in place will also help when it comes time to sell the practice since it provides a podiatrist with more flexibility when structuring the sale. Unlike a podiatrist or business owner with no retirement savings, a principal or owner with the security of a defined-benefit plan is usually in a better position to negotiate the best price or terms.

A Warning and Putting It in Writing

Podiatrists operating their practices as pass-through entities such as S corporations, partnerships, and LLCs should be aware that there can be too much of a good thing in the eyes of the IRS. The rules penalize the "accumulated earnings" left in pass-through practices and businesses with a hefty tax.

Avoiding the onerous accumulated earnings tax and other potential pitfalls in the nest egg or the reinvest decision-making process illustrates the importance of financial planning. While planning shouldn't be underestimated, it should be in writing. For one thing, if you write it down, you won't have to worry about remembering all of the factors that contributed to your plan. If circumstances change, updating that financial plan will require much less time and effort.

The skills that serve so well in operating and growing a podiatry practice may not serve when it comes to investing money taken from that practice. Although some podiatry professionals are great investors, how, in all honesty, can anyone who devotes 60, 80 or 100 hours a week to their practice compete with investment professionals?

Fortunately, a legion of professional advisors stands ready to help every podiatry professional: lawyers, accountants, financial planners, stock brokers, bankers, insurance agents, and the like. Shop for an adviser as you consider whether to re-invest in your podiatry practice or create a separate nest-egg. PM

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