Financial Advice for High-Income Doctors

The author in a place where a high income does you no good at all-
Bonus points if you can identify the four peaks in the photo

One of my advertisers, insurance agent and CFP Michael Relvas, suggested I do a series aimed at high-earning physicians. He agreed to do a bit on disability insurance for these folks, while the other two posts in this series will address other financial issues.

One of the underlying themes of this blog is that the vast majority of doctors don’t make THAT much, and typical physician incomes range from $150-400K per year. Doctors in this income range are far more similar to their engineer, attorney, accountant, or small business owner friends than they are to investment bankers and Britney Spears. Estate planning issues are minimal, asset protection needs can generally be met with insurance and retirement accounts, and their retirement and investing needs can generally be met using relatively standard retirement accounts. There is little need to mix insurance and investing, aside from the purchase of a single premium immediate annuity (SPIA) in retirement to provide a base level of income. The main issue the typical doctor needs to address to be successful is to set an appropriate amount of spending (and thus saving), minimize investing costs and taxes, and ensure an adequate insurance plan. For a relatively high-earning family, such as a physician making $500-2 Million per year, a two-physician couple, or a physician whose spouse is also a high earner, things can get more complicated.

This post will address investing and tax considerations, the second post will address disability insurance specifically, and the final post will address non-disability insurance, estate planning and asset protection issues applicable to these high-earners.
Favor Roth Accounts

The high earner should generally favor Roth (after-tax) over traditional (pre-tax) retirement accounts for several reasons. First, because Roth money is after-tax, you can put more money into the account, which means more money growing in a tax-protected manner and less in a taxable account. Second, for estate planning purposes, it is far better to inherit a Roth IRA than a traditional IRA, and since a high earner ought to have a higher net worth and thus leave more money behind to heirs, better to have it in Roth accounts. Third, if you’re in the highest bracket now and expect to be in the highest bracket upon withdrawal, there is little “tax-rate arbitrage” that will be happening. For most Americans (and most doctors) they’ll be withdrawing money at an effective tax rate far lower than their marginal tax rate at the time they put it into their retirement accounts. That’s probably not true for someone making $1 Million a year for several decades. Roth accounts also provide you with a significant hedge against higher future tax rates. There is still value in the tax diversification provided by having some tax-free and some tax-deferred accounts, but the value decreases as your income and assets climb.

Pay A Fair Price For Advice

Most fee-only financial advisors charge based on a percentage of assets under management, with 1% per year being a typical fee (although much lower rates are available.) 1% of a $1 Million portfolio works out to $10,000 a year, which while expensive, isn’t ridiculous. 1% of a $10 Million portfolio ($100,000) is way too much to pay someone to manage your assets, much less for financial advice. It simply isn’t that much harder to manage a large sum as a more moderate sum. If you have a high net worth, you need to negotiate your financial planning and asset management fees very carefully. You should either pay a flat rate as an annualized retainer or the asset management fee percentage should be significantly reduced for additional money being managed. Don’t assume that just because 1% of $500K is fair that 1% of $15 Million is also fair.

Learn To Manage A Taxable Account Well

Many doctors, such as myself, have little need for a taxable account. We often have more space available in our retirement and other tax-protected accounts than we have money to save in them. A high-earner, however, will almost surely have some taxable money. This money needs to be invested in a tax-efficient manner. You can do this by minimizing turnover, using specific “tax-managed” or index funds, using municipal bonds (especially for your state) over nominal bonds, tax-loss harvesting, and preferentially placing your least tax-efficient assets into your retirement accounts. If you give money to charity, you should donate appreciated shares from this account.

Don’t Take More Risk Than You Need

Remember when designing your investment plan that you need to consider your
need, ability, and desire to take risk. One benefit of a high income (and hopefully net worth) is that you may have much less need to take risk than someone making or having less. If you run the numbers, you may find you can essentially save up all the money you’ll need in retirement without taking on significant investment risk. There is great wisdom in not running a risk you don’t have to run. Instead of a more typical 60/40 portfolio, you may find you can meet your needs easily with a 25/75 portfolio.

You Still Have To Budget

Just because you make a lot of money, doesn’t mean that good financial principles no longer apply. A million dollar income can be blown just as easily as a $200,000 income. High earners still need to save at least 20% of their income toward retirement. They should still save up to buy large ticket items and avoid credit cards. Their mortgages should still be within the realm of sanity (my general rule is your mortgage shouldn’t be more than 2X your gross income and housing should consume no more than 20% of your gross income.) Remember that it’s all the same game whether you’re making $50K a year, $200K a year, or $1 Million a year. The rules don’t change, only the number of zeros.

Remember The Lowly 529

Few Americans, even doctors, can actually max out available 529 accounts. They’re really a tax break for the rich. I have three children, and current law allows me to put in $14K per year into each of their accounts. It also allows my wife to put in the same amount. That’s $86K per year total, far more than I can afford. But a high-earning physician could. Even better, you can “front-load” with 5 years of contributions up front. That’s $140K per kid for a married couple. Keep in mind that each state has a different limit on 529s. Once the 529 hits the limit, you can no longer make contributions. In Utah, that limit is $397,000 per beneficiary. They don’t count contributions to other state 529s, however, and your account can easily grow to more than that. You still don’t want to put more in there than you anticipate the kid will spend on education, since earnings not used on education are subject not only to taxes, but also a heavy 20% penalty.

Don’t Worry About the AMT

One nice benefit of being a high-earning doctor is that you no longer have to worry about the Alternative Minimum Tax (AMT.) This tax generally affects those with taxable income between $150-415K. If you’re making twice that, at least you have one less thing to worry about and plan around.

Consider Cash Value Life Insurance

Although it pains me to say it, as I’m generally one of the internet’s harshest critics of mixing insurance and investing, the higher your income the more sense investing in an appropriately designed cash value (whole life or variable universal life) life insurance policy can make. (For lower
income folks, I think Dave Ramsey is absolutely right when he calls it the “payday loan of the middle class.”) High earners have maxed out available retirement accounts, are in and expect to stay in the highest tax brackets, have less need for high returns, and are more likely to gain maximal benefit from any estate planning and asset protection features. It’s still reasonable to invest in tax-efficient mutual funds or tax-preferred real estate instead of life insurance (especially if your costs of insurance are relatively high), but the difference isn’t nearly as vast as it would be on a typical physician income. Bear in mind that if you choose to invest in a cash value life insurance policy that it should be set up as much as possible as an investment from the beginning. That generally means minimizing the death benefit, overfunding it to the MEC line, minimizing insurance and investing fees and expenses, funding it annually (instead of monthly), having it “paid up” as soon as possible to minimize required future payments, and perhaps most importantly, ensuring only a reasonable percentage of your assets are going in to this investment vehicle.

Mo’ Money, Mo’ Problems

Unfortunately, being a high-earner means there are fewer people around in your situation and that means you’ll have many more opportunities to be swindled. This includes being sold cash value life insurance inappropriately, being pushed into a “special” retirement account that probably isn’t superior to a taxable account for you, and being offered private investments (real estate funds, private equity funds, hedge funds, surgical centers, radiology centers etc) that are either too expensive, or worse, run by scoundrels. Due diligence becomes far more important than if you were just maxing out your profit-sharing plan. The good news is that purchasing background checks on the principals of these funds ($3-4K a piece) becomes a little more reasonable when you’re investing large amounts.

“Special” Retirement Accounts

There is a plethora of retirement/business/asset protection arrangements out there aimed at the high earner. The rules for these can get sticky, and they’re not well-known. Many times, they’re sold completely inappropriately. For your situation, however, the tax or asset protection benefits may be worth the additional expense and complexity. These accounts include:

- Cash Balance Plans
- Defined Benefit Plans
- 412(i) Plans
- California Private Retirement Plan
- Captive Insurance Companies
- Business Interruption Equity Trust
- Malpractice Insurance Equity Trust
- Equity Disability Trust
- Accounts Receivable Leveraging
- Accounts Receivable Business Continuation (ABC) Plan
- Non-qualified Deferred Compensation (NQDC) Plan
An entire post could be written about each of these, and each scheme cannot be explained here due to space limitations. Prior to instituting any of these plans, I suggest you get multiple opinions and be sure you thoroughly understand what you’re purchasing, and what benefits it provides you in comparison to a taxable account, and at what additional cost and risk.

Next time we’ll discuss how to maximize disability insurance benefits if you’re a high earner.

What do you think? Are you a “high-earning” physician? How has that affected your finances? Have you reached for any creative solutions?