just for dentists

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# Top 5 money mistakes dentists make

Earning a high income does not guarantee financial security in your old age. Have you ever wondered why some colleagues with lower billings seem financially better off than you? What are they doing that you are not?

Here are some serious money mistakes dentists make, and ways you can avoid them.

## 1. No written goals

Researchers at Yale University conducted a follow-up study of alumni 30 years after graduation. They found that those students who had written a financial plan when they graduated owned more than 90 percent of the total wealth of the class. The message: write down your goals and take ownership of them. They must be practical and specific, such as reducing the house mortgage by $50,000 this year. It is also important that you and your spouse work as a team in order to ensure success.

## 2. Too much tax

Unlike colleagues in other provinces, B.C. dentists have a unique advantage that allows them to fully utilize the tax savings and income splitting features of their dental corporations. Income taxes are your biggest expense, so we are always amazed at just how few dentists engage in serious tax planning. Make tax planning your top priority. Usually the tax savings generated are sufficient to significantly enhance your retirement nest egg.

## 3. Too much debt

Dentists often take on large personal debts without understanding the cash flow implications. It takes $1-million of your precious practice cash flow to pay off a $300,000 house mortgage. This means that the cash flow is not available to finance your children's education or to be invested in your retirement plan. If you are still struggling with debt prior to your retirement, you will likely end up with little more than your residence and your RRSP investments, such as they may be.

## 4. Inappropriate investments

Many dentists abdicate responsibility for their own money by having advisers make all of their investment decisions. Nobody is asking you to subscribe to the Wall Street Journal; however, you should be proactive in deciding with your adviser how your money is to be invested. You need to ensure that your portfolio meets your long-term objectives and risk profile. Keeping surplus cash in interest-bearing accounts is not the answer. Once you deduct income tax of almost 50%, as well as an inflation factor from your 5% investment return, you will find that you are just treading water.

## 5. Living beyond your means

No matter the size of their pay cheques, many dentists still spend every dollar, and more, on personal and living expenses. Start living by the 10 - 90 rule: each month you write a cheque equal to 10% of your monthly practice billings to your investment account, and live on the remaining 90% of your earnings.

Remember, a financial plan is worthless unless it is put into action. Follow Nike's slogan: Just Do It! Give us a call, or e-mail us, if you need help getting started.

## What we do best

- Help you plan and successfully execute your practice transition.
- Structure associateships and practice purchases.
- Prepare practice valuations and marketing prospectuses.
- Organize successful group practice arrangements.
- Provide you with leading-edge tax, financial and estate planning advice.

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*Insuring wisely*

# The Universal Life premium blues

Ten years ago, at age 30, Dr. Al Dente took out a $1.5-million universal life policy to provide for his children and to pay the capital gains taxes on death. He has been paying the after-tax premium of $600 per month for ten years. The policy has a cash value of $15,000—not very much when you consider that the total premiums to date have been $72,000.

Given the steep premiums, Dr. Dente is questioning his original motives behind the purchase of the universal life policy. On reflection, he realizes that he really only needs the insurance for the next 10 years. Having $1.5-million available when he dies at a ripe old age is a luxury, not a necessity.

With the help of his agent, Dr. Dente uses the existing cash value to fund a term policy for the next 10 years, rather than continuing with the universal life program. This new insurance policy costs $100 a month, an annual premium reduction of $6,000.

Before you sign up for a permanent insurance plan, you need to ensure that you have an absolute need for it—otherwise, you are wasting your precious after-tax cash flow.

Remember, insurance is there to provide cash to cover a financial loss; it is not an investment, per se. While this may seem obvious, there are still many dentists who purchase universal life policies just to gain access to its tax shelter. If you have no real need for long-term life insurance coverage, then the price for its tax shelter benefits is too steep because a large chunk of your premiums are used to fund the mortality charges of the policy.

# Why IPPs are so popular

If you are in a hurry to build up your retirement savings, consider an Individual Pension Plan (IPP). Here is an illustration of how one dentist, Bob, age 60, used the IPP to his benefit.

Under an IPP you are eligible to make a past service contribution. One benefit of an IPP is that it allows for larger contributions than RRSPs. In Bob's case, he was able to make a $72,000 past service contribution.

The maximum annual pension benefit is 2% of the final average salary (maximum $86,111), or $1,722.22 for each year of service. After 2004, this benefit increases by 5.5% per year, for each year of employment with the company.

| Year | Age* | IPP Contribution | RRSP Contribution |
|---|---|---|---|
| 2002 | 60 | $ 93,919[1] | $ 13,500 |
| 2003 | 61 | 22,831 | 13,500 |
| 2004 | 62 | 24,543 | 14,500 |
| 2005 | 63 | 26,384 | 15,500 |
| 2006 | 64 | 28,363 | 16,353 |
| **Total** | | **$196,040** | **$ 73,353** |

* Beginning of the year
[1] includes past service contribution

In our scenario, Bob's salary is $100,000, so his annual pension benefits will be capped at $1,722 for each year of service. If Bob decides to receive income from this IPP when he turns 65, he will have 15 years of service (contributions started in 1991), which will provide him with an annual pension of $25,830.

What else should you know about Individual Pension Plans?

1. IPP funds can be invested in any pension-eligible investment such as stocks, bonds, mutual funds or pooled funds, GICs, etc. The pension fund can have investment flexibility just like a self-directed RRSP. Pension fund investments follow the general "Prudent Man" standard for trust funds. The key requirements are investment quality and diversification.
2. The company can deduct interest on money borrowed to make the IPP contributions. As you already know, interest paid on RRSP loans is not deductible.
3. If the investments inside the IPP perform poorly, you must increase your IPP contribution to make up the deficiency. With an RRSP you cannot.
4. An IPP is more costly to set up and maintain than an RRSP: the set up costs are approximately $2,000 with an annual cost of about $500.
5. You cannot access your IPP funds as long as you are an employee of your dental corporation.
6. An IPP does not provide you with an income-splitting mechanism like the spousal RRSP does.

The Individual Pension Plan is not meant for dentists who have managed to build a million-dollar portfolio by age 40. The IPP can be a magic bullet, however, for those who fear they are running out of time to build a comfortable retirement nest egg.

# Turning 50? So what?

Turning 50? Showing battle scars from working in the trenches of dentistry for 25 years? Experiencing symptoms of andropause, the curse afflicting male baby boomers?

As they approach 50, many dentists begin to realize that they will not practice forever, and that they may have only ten years of active practice life left. Many come to face the reality that they had better get their financial acts together and begin implementing some smart saving strategies.

In the absence of planning, you too will end up like 85% of retired dentists who lack the financial resources to enjoy the retirement lifestyle they were counting on.

**As a rule-of-thumb, use the factor of "25" if you anticipate retiring at age 60, and the factor of "20" if you anticipate retiring at age 65.**

The answer to the question "What should be the size of my retirement savings?" will dictate when you can afford to quit dentistry. As a rule-of-thumb, use the factor of "25" if you anticipate retiring at age 60, and the factor of "20" if you anticipate retiring at age 65. In other words, decide at what age you wish to retire, then multiply your after-tax required income by either 25 or 20. For example, if you require $60,000 of income per year, you will have to save $1.5-million by age 60 ($60,000 x 25).

When it comes to their investments, many dentists are either too conservative or they take on too much risk. If you want to outlive your investments, you need to have the right investment strategy, with emphasis on asset allocation, to suit your financial profile. The investment strategy should be long term, and unaffected by market conditions or the opinion of stock analysts.

If you only invest in no risk, low return investments, you will fall short of your investment goal. You need to invest in equities. To illustrate: if you invest $2,500 per month for 20 years—with an after-tax investment return of 3%—then, in 20 years, you will end up with $800,000. With a better asset allocation, increasing that return to 5%, your investments will have grown to $1,000,000—or $200,000 more.

You will also need to implement the correct practice transition strategy in order to maximize the value of your practice upon retirement. What is the best transition model for your practice? Will it be a straight retirement sale for cash, or does the size of your practice justify a 'salami sale' to two or three dentists?

You will need to find a practice transition model you think will work best for you. Having been involved in many practice transitions, we have learned that there are no easy answers. Often, the practice transition strategy a dentist initially had in mind is not the most appropriate one to use.

With our extensive practice transition experience, we can assist you in developing the best strategy to ensure a successful transition that takes into account your unique financial and practice circumstances.

# Q&A *sk the Experts*

***Q:* Are there ways to avoid the income splitting tax, so that I can use my family trust again?**

***A:*** There are a number of strategies to consider. For instance, the share sale strategy will allow you to continue to avoid the income splitting tax. Here's how it works.

Suppose you have a dental corporation and a dormant (due to the "kiddie tax") family trust of which your three minor children are beneficiaries. Also, suppose that the value of the shares owned by the family trust is $700,000, which includes the value of the practice and the strata office.

Here is a scenario to regenerate family income splitting by converting dividends (which are subject to the "kiddie tax") into interest income, which is tax exempt.

1. Establish a new trust.
2. The old trust sells its shares to the new trust for $700,000. The capital gains exemption shelters the tax on the sale.
3. The new trust issues a 6% promissory note for $700,000 to the old trust.
4. The company pays dividends to the new trust equal to the interest paid to the old trust on the promissory note.
5. The new trust pays interest of $42,000 to old trust. New trust claims interest expense against dividends. The old trust allocates the interest income to the three children for tax purposes.

In the above scenario the potential annual tax saving is about $14,000—a great cash saving considering that it costs only about $2,000 to implement such a plan.

# F.S.B.O.–tips on selling your practice

Are you thinking of selling your practice on your own? Here are some "must do" tips.

## 1. Set a realistic market price

Keep in mind that purchasers may pay little attention to the practice valuation. Asking for the moon and having it supported by a beautifully bound valuation report is a waste of time and money. Price is seldom an issue in sale negotiations, unless your asking price is inflated.

## 2. Prepare a marketing prospectus

A one-page prospectus is a great tool for getting your prospect excited about your practice, and it's a great way to set the "hook." The prospectus should include your overall transition plan, your practice profile, and a financial summary. Remember, you don't get a second chance to make a good first impression—a prospectus ensures a great first impression!

## 3. Plan your negotiation strategy

Prepare yourself thoroughly for negotiations. Practise what you intend to say. Get assistance from a knowledgeable adviser. It is important during the initial stage of negotiation that you deal directly with the prospective purchaser. Bringing in the "heavy hitters" too soon during early stage negotiation meetings may cause your prospective purchaser to be less inclined toward making compromises. Direct negotiating helps you build rapport with your prospective purchaser which translates into a better deal for you.

## 4. Prepare a letter of intent

Once you and the prospective purchaser have settled on the main issues, it is crucial that you—and not the prospective purchaser— summarize important points in a "letter of intent." After discussions and fine-tuning, the finalized letter of intent must be signed by both parties. This letter will be the basis from which the lawyers will prepare all legal documentation.

## 5. Insist on a good-faith deposit

Your letter of intent should include a requirement that the prospective purchaser makes a minimum deposit of 10% of the purchase price upon signing. The fact that the purchaser seems committed to the deal means absolutely nothing, unless the commitment is backed up with cash.





RETURN REQUESTED


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