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How Practices Can Reduce Taxes

by Steven Podnos, Md, Cfp • Nov. 23, 2015 • 1 min read • original

One of the most common questions I get is how to reduce taxes. My first answer is always to have and fully fund a retirement plan with pretax dollars. It is rare that a practice would not be able to do this in a tax efficient manner. I can think of no better way to build wealth and it is with Uncle Sam helping out.

The main benefit of the retirement plan is the ability to deduct contributions while in a high-tax bracket (in the earnings years). Both the contributions and the earnings on them (which can easily be a multiple of contributions given decades of a plan's life) grow tax deferred until distributions are taken. At that time, most participants are in a much lower tax bracket (and to great benefit).

Another great idea is to use a business as a way to take deductions. If you have your own practice, this is a given. But, even if you are employed, it probably pays to start a side business with which you are paid independently. This then allows you to take many regular business deductions associated with your practice (and more) that you cannot as a strict W2 employee. Also, note that you can have a separate retirement plan for a side business. You can pay older children to help with the business, funding their education with tax deductible dollars. In fact, if you are a sole proprietorship and the children are under 18 years old, there may be no federal income tax or social security taxes on some or all of the tax deductible income you pay them.

If you have a suitable "qualified" health insurance plan, a Health Savings Account is yet another way to save on taxes. In fact, an HSA is the only way in which you never pay taxes on some income. You get to deduct the contributions from your income taxes and then have the earnings grow tax free. Withdrawals are also tax free as long as used for healthcare expenses.

College Savings Plans (and tuition prepaid plans) are another way to avoid taxes on investment earnings, available to those who wish to help with educational costs of children and/or grandchildren. Buy these plans directly from your state or from a "no load" brokerage such as Vanguard or Fidelity.

Another way to reduce taxes is to change how you receive some of your investment income. If you are in a high-tax bracket, changing some of your fixed income to municipal bonds may make sense. Additional approaches include trying to avoid short term capital gains and trying to make investments long term to avoid taxation while they grow in value.

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