SINCE 1994

MOSAIC
FINANCIAL ASSOCIATES

THE THREE GREATEST RISKS TO YOUR WEALTH

Some ten plus years ago, we were asked to define our practice in one sentence. What is it we do? *We help orthopaedists and their families grow their net wealth in a tax-efficient manner while minimizing exposure to litigation.* Plainly stated, the goal is to help clients grow and protect wealth while eschewing the risks doctors face. Let's discuss the three greatest of these risks in more detail.

RISK 1) TAXATION

Many clients focus first and foremost on the question of how to lower their tax liability now. While this question is important, one should also ask: "How do I lower tax liability as I grow my wealth?" and, "How do I lower my tax liability when distributing my wealth in the future?" We've witnessed a majority of people focus primarily on saving taxes today with little regard for the impact of taxation during the accumulation phase, and virtually no thought as to how taxes will impact their net wealth in the future.

- Today: Taking advantage of your pre-tax savings plans such as a 401k, 403b, SEP IRA, or Profit Sharing Plan will lower your tax liability in the year in which you contribute. For example, if you earn an annual income of $350,000 and contribute $53,000 of that to your employer-sponsored 401k or Profit Sharing Plan you would lower your tax liability by approximately $18,000 for that year[i]. Notice we didn't say "save" money in taxes, but strategically used the word "lower" to describe the affect. In our opinion, this is more than a simple matter of semantics because it is important to remember that at some point you will pay taxes on these monies. Where do you think federal tax brackets will be when you access this bucket of wealth? Based on demographics alone (the number of baby boomers in this country will double in the next twenty years)[ii], the likelihood of federal tax brackets increasing is high due to the incredible strain placed on Social Security, Medicare, and Medicaid. Couple this demographic shift with the heavy spending in the previous and current administrations and one conclusion comes to bear: Your retirement allocation must be balanced accordingly between taxable and tax free sources of income.

- During your career: Here are some important considerations while you are earning income and building your wealth:

  - ✓ Are your assets growing tax-efficiently?
  - ✓ Are you maximizing your growth using the impact of compound interest?
  - ✓ Are your investment vehicles adding to your tax liability?
  - ✓ Further, what is the lost opportunity cost associated with these taxable investments?

To illustrate these questions, consider this example. Imagine that your investments for the year generated a $10,000 tax bill due to capital gains tax, etc. The lost opportunity cost represents how much that $10,000 may have grown over 30 years if your assets had been structured in a tax-efficient way that allowed you to avoid the tax and keep the $10,000 invested.

A simple tip to help you determine how much your money will grow is The Rule of 72[iii], whereby you take your expected rate of return and divide that number into 72. The resulting number reflects how many years it will take for your investment to double. Therefore, using our example above, and estimating an 8% rate of return, the $10,000 would double every nine years. That would result in $40,000 in 18 years, and $80,000 in 27 years. We often say to clients to express the true impact of paying this tax: "It's about much more than the $10,000 in extra tax you are paying today; it's also about losing out on the $40,000, $80,000, or more that you sacrifice by not investing tax-efficiently."

- Retirement and Beyond: As you begin to withdraw money for living expenses from your various retirement accounts, the drains on your wealth include: the rising cost of living, medical care, and taxes. Many have been led to believe they will be in a lower tax bracket in retirement than they were pre-retirement. Are you one of them? For most investors, this notion is misguided for several reasons:
  - You will no longer have retirement contributions lowering your tax liability.
  - You likely will not have the interest deduction on your home.
  - You likely do not wish to lower your standard of living? Or perhaps you will.

Here's the deal. If you are a diligent and disciplined saver, you should expect to have a fairly significant net wealth at age 60. This said, even if you only peel off enough income to keep you in a lower tax bracket in retirement, you likely are taking less than the interest will be earning. The result is that your wealth continues to grow. Think of a snowball going down a hill: it grows largest at the bottom!

If you only peel off a small amount relative to the entire balance you are setting yourself up for a vital challenge. The IRS Age 70½ Required Minimum Distribution rule carries a heavy burden whereby the IRS becomes your business partner and dictates all the terms. Effectively, you must begin mandatory withdrawals from your tax-deferred qualified retirement accounts (401k, SEP, 403b, profit sharing plans, etc.) at a pace quickly enough to liquidate those accounts by your estimated mortality (if you don't elect this distribution, in addition to taxes you are hit with a 50% penalty). For example, assume you have $4 Million in your taxable accounts at age 70½ (remember, these monies are taxed at distribution) and you are earning 4%[iv]. Let's also assume an age 85 mortality rate. In this illustration, the RMD would require you to withdraw 1/15 of your principle balance annually-- roughly $267,000 in addition to the interest of $160k. The IRS will now have more control over your tax bracket than you do.

RISK 2) LITIGATION

What orthopaedist isn't concerned with the effect of being sued? Who isn't afraid of having some type of lawsuit take your accumulated wealth?

Asset Protection is a key planning concept which is often overlooked. There are certain

investment vehicles which provide automatic protection against creditors and litigation. Additionally, in some states, insurance company assets are also protected from these risks. A qualified financial planner can help identify these basic asset protection vehicles. Beyond these however, we believe that it is critical to identify a professional whose sole purpose is to protect your assets.
One Asset Protection Attorney, whom we consider a trusted colleague, has a simple yet powerful maxim, "Own nothing. Control everything." Through a variety of simple to complex legal structures and strategies, this attorney works with his clients to provide assurance that their net wealth is protected. It just makes sense to dedicate some of your time and resources in addressing this serious issue.

RISK 3) INCOME LOSS

Your journey to financial freedom will stall if you have no means to regularly gas up your vehicle. The issue of income loss is one which will prevent you from accumulating wealth. Multiply your income by
2.5 years, which is the average length of disability for adults[v]. How long would it take you to accumulate that amount of money? How long could you go without your income? Are you prepared to cover your expenses for any period of time? What about your ability to continue saving? This tragic detour can be avoided.

Our suggestion when evaluating disability insurance is to acquire True Own Occupation coverage. The definition of disability for doctors' insurance should read: "The inability to perform the material and substantial duties of your own occupation (recognized specialty)." This means that if you are unable to perform the functions required to earn your income in your chosen occupation, you are considered disabled, even if you are able to earn income in some other fashion. Many people we've met through the years have disability insurance contracts in place which include the definition above with an add-on stating, 'so long as you are NOT working in any other capacity.' The difference is considerable. Are you covered properly?

Relative to the amount of money you risk losing should you become disabled, the amount of premium you will pay to insure this loss with disability insurance is reasonable if not insignificant.

We hope you NEVER collect on your disability insurance. As a doctor, you know all too well that people don't plan to become ill, have an accident, or receive a critical diagnosis. What would you pay for the peace of mind that comes with knowing that your lifestyle and retirement savings will continue on even in the event you can no longer earn?

---

i. This illustration uses current tax rates.
ii. U.S. Census Bureau statistics; www.census.gov

The Rule of 72 is a mathematical concept and does not guarantee investment results or function as a predictor of how your investment will perform. It is simply an approximation of the impact a targeted rate of return would have. Investments are subject to fluctuating returns and there can never be a guarantee that any investment will double in value.
iv. For this example, we assume a lower rate of return, due to expected conservative, lower risk investment strategy in retirement.

v. From “Disability Statistics” published by the Council for Disability Awareness. Additional information is available at the council’s website, www.disabilitycanhappen.org, which compiles data from the US Census and Social Security Administration

This article intends to offer general information on the subjects discussed and should not be regarded as a complete analysis of these subjects. Any tax or legal information in this piece is merely a summary of our understanding and interpretation of current laws and regulations and is not exhaustive.

Distributions from traditional IRAs and employer sponsored retirement plans are taxed as ordinary income and, if taken prior to reaching age 59½, may be subject to an additional 10% IRS tax penalty.

ANTHONY C. WILLIAMS, CWS, CHFC, RFC, CLU & MARCUS E. ORTEGA, CHFC, RFC

Investment Advisor Representatives

Mosaic Financial Associates | 960 W Elliot Rd. Suite #213 Tempe, AZ 85284

Ph: 480-776-5920 | www.mosaicfa.com