Financing an Office, Personal Investments, and Money Management*

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Today's medical doctor is very much like today's lawyer, engineer, or accountant in that he is trained very highly in his own field, but has received very little educational background for successfully managing the office he operates. Although I am not an expert in any of the areas which I am about to discuss, I would like to pass along some observations, most of which are drawn from experiences I have had while practicing as a CPA. There is no set way to handle many of these problems, and I can only present some of the pros and cons I have heard and experienced over the years in these different areas.

The first question that comes to mind when one considers financing an office is that of lease versus purchase. Generally, the main advantages given for a lease are the current deduction of the rental or lease payments for income tax purposes (a tax advantage) and the improvement of the lessor's balance sheet as a result of not having to include as a liability the money borrowed for the purchase of the asset (a financial advantage). In most instances, there no longer exists any tax advantage in leasing. The tax law now permits what we call accelerated depreciation which usually affords as much deduction for purchasing. More often, the outright purchase of the asset will result in greater tax deductions in the earlier years than leasing. The financial advantage of improving the lessor's balance sheet could be worthwhile in some instances. However, I doubt if many doctors will have much of a problem with the acceptance of their personal balance sheet by financial institutions over their years of practice. The only way to really figure the comparative cost of a lease or a purchase is to take into consideration all of the tax and financial factors. I believe, however, that for most items, including automobiles and office equipment, the cost will be greater when an item is leased than when it is purchased.

There are many methods of financing. An important factor is the advantage doctors have over other people seeking to borrow money for somewhat the same purpose. While many doctors will not have very good financial statements, or for that matter very good earnings records when they first set up practice, banks recognize their potential earning power, and in most cases are eager to do business with them. When dealing with a bank, one should keep in mind that usually they have two departments in which they make most of their loans. The first of these is the installment loan department common to all banks, and it is from here that they generally prefer to loan money. The reason for this is simply that consumer or installment loans for the most part carry a much higher interest rate. The other department is the commercial loan department, and it is here that customers are charged the better interest rates. When borrowing money from a bank, one should make sure they quote the effective simple interest rate, because a simple interest rate of 6% is about 60% of a 6% installment interest rate. Often, if the borrower says nothing, the bank will give him an installment interest rate loan, so it is very important for a doctor to let the bank know that he is aware of the difference.

Equipment suppliers are another source of money when funds are needed for setting up an office. Since the financing of the equipment is just one part of the total purchase arrangement, it is often possible to get just as good a deal from the supplier as it is from the local bank. However, in general the interest rates charged by equipment suppliers are greater than those charged by a local bank and other financial institutions.

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Small Business Administration has commercial programs which, though not specifically designed for doctors, permit them to loan money to these professionals. One particularly good area is the loans they will make for a doctor to construct an office building. Although the SBA has had a reputation for requiring a lot of red tape, this is no longer true. An SBA loan now presents no more difficulty than a similar loan secured from a bank. In addition, it is possible to save interest costs, because in many instances the SBA will lend money at lesser rates of interest than can be obtained commercially.

Whether or not a doctor buys or leases office space depends a great deal on the town in which he practices. The medical buildings constructed through a cooperative effort by doctors in our area have been extremely successful. Not only have they proven beneficial in terms of the doctors' practices, but also the doctors' stock investments in the corporations established for this purpose have greatly appreciated in value. Thus, the cooperative construction of medical buildings is a good way for a doctor to acquire the type of office space he wants at a desirable monthly rent and at the same time make an attractive investment in the capital stock of a growing corporation.

Working capital may or may not be a major item to finance. If a doctor's practice is properly managed it should require very little working capital; if poorly managed it will take a great deal. The most significant factor in this category is the accounts receivable. These are usually the most difficult to control. Even if a doctor does a good job of collecting his receivables, he should keep in mind that when he sets up a practice, a large part of his work will go on the books and that it will be 30, 60, or 90 days before he collects some of his accounts. With this in mind, when he first talks to a banker, it might be a good idea for him to request that some additional money be included in any loans he receives, to pay his office and personal living expenses for two or three months.

A doctor who sets up his office operations properly should start making money. Once this happens he will become very conscious of the taxes he is paying and the little amount he is able to set aside for savings or investments. In general, there are two reasons why people take some of their current income and set it aside for an investment or savings program. First, is the desire to save taxes. Second, is the wish to lay aside something for a rainy day. When investing for tax savings, beware of salesmen and brokers selling tax sheltered investment programs. Certainly most of these people are honest, competent, and reliable but there are, unfortunately, many who either misrepresent what they are selling or who are simply incompetent. Doctors should also be aware that most revenue agents, and the Internal Revenue Service as a whole, dislike tax sheltered programs and will give you a rough time about them when your tax return is examined. Also, many of these programs are covered by tax laws and regulations which are very vague and which can be interpreted differently by the Government and the taxpayer.

Investments in the oil and gas industry enjoy a significant tax advantage. But this is an area which the Government is starting to attack, and many of the programs sold by salesmen and brokers are not as black and white as they may seem. Recently there have been three or four cases reported in *The Wall Street Journal* where the Internal Revenue Service is taking to court several limited partnerships which had millions of dollars invested by ordinary professionals. If won by the Government, these cases will result in disaster for the investors concerned. Thus, any investment in the oil and gas industry should be investigated thoroughly, and it is a good idea to have a tax adviser review the program before money is put into it.

Real estate is becoming popular with high income people because it is one of the few investments that can be paid for from the income of the property. It is difficult to pay for stock with just the dividends one receives, but it is often possible to pay for a building with the rent received. Real estate enjoys a significant tax advantage in that in the early years the owner gets to depreciate, or write off, the cost of the building in addition to the interest he is paying on the loan, and the total of these two is sometimes greater than the rental income received which results in a tax loss. In the last couple of years we have seen the formation of many limited partnerships in Virginia which are established to enable the high income investor to make an investment without the risk he would normally incur as the sole owner or as a general partner in a partnership. I believe that real estate is a good area in which to invest if some tax advantage is desired and appreciation rather than income is your investment goal.

Agriculture is a big enterprise, and all of us have heard about doctors who buy farms to save income taxes. This is not as easy as it once was, and many farm losses are now being disallowed because of the Government's position on hobby losses. However, a farm, even if run for profit, can be a very attractive tax-savings vehicle and one that, if managed and operated properly, can reap significant returns over the years. In recent years, many large argicultural companies have been forming limited partnerships to enable the ordinary investor to make an investment in some sort of an agricultural program. Most of these partnerships are cattle operations, and most of them involve significant tax write-offs, which are sometimes more than the investment itself in the earlier years. A lot of people have gotten burned while making investments in this area simply because the cattle that were put into the limited partnership by the general partner (usually the seller) were priced too high, and it was impossible for the investor to ever come out even. However, again through thorough investigation and consultation with a tax adviser, it is possible to make an investment which will save some taxes and at the same time result in some savings.

There are also many tax advantages in qualified profit sharing and pension plans, and probably more people set up these plans for the tax advantages than for the investment advantages. If tax shelter is desired and if there is money to set aside and save, in my opinion this is the very first direction that one should take to accomplish these objectives. Such programs are tax deductible (a tax shelter), and one is given a great deal of flexibility as to the nature of investments from which one chooses.

Tax-free bonds offer yields which vary with the times. In other words, economic conditions influence the rate of return that one receives. Just two years ago, it was possible to invest in these bonds and receive rates that are unheard of now. These bonds offered a very good investment at the time; however, since then, the rate of interest paid to the bondholder has decreased, and now a person has to really look around before he can find tax-free bonds that compare favorably to some of the taxable commercial bonds that are available for investment.

For those who want to invest for reasons of security and who are not interested in a tax shelter program, there are the recognized principal areas of investment. I should mention at this point that everyone ought to have some savings such as a savings account in a bank or a certificate of deposit which can be used in case of emergency. I have heard many times the suggestion that a man's investments ought to be in two principal areas. Fifty percent should be of the kind that vary up and down with the times, such as stocks and real estate, and the other fifty percent should be of an invariable nature, such as savings accounts and insurance, which are always available if needed. As a variable area of investment, stocks and bonds are unique, and it is recommended that one obtain a competent adviser in this area. For professional men to get involved in the stock market to the extent of being their own adviser is very impractical and foolish.

It is possible sometimes to make investments in closely-held companies that reap a much larger return than could be obtained in the stock market. However, because of a doctor's income and status in his community, he will be approached often by people who want him to make an investment in some kind of deal they have put together. Many of these schemes will be good, but there will be a significant number that are bad. Here again, careful investigation is recommended. So many times I have seen doctors, like other high income individuals, invest in a small company with disastrous results simply because they did not take the time or seek the counsel necessary to insure that they were making a sound investment.

Insurance is an item that inspires many different opinions. Most doctors will need a fair amount of insurance until their children are through college and most of their debts are paid. There are two schools of thought regarding the type of insurance one should buy. One contends that term insurance is all that is needed, and the other believes that everyone should buy permanent insurance. The difference in the two is basically this: Term insurance in the long run is generally the more expensive. But if you do not have an abundance of cash, particularly in the earlier years of your practice, term insurance will provide protection with much less out-of-pocket cost. When considering life insurance, one should not overlook some sort of plan for income protection. For most doctors, their greatest asset will be their education and ability to practice as a physician. It is as bad financially for a doctor to become disabled and cease having any income as it is for him to die.

I just want to say two things regarding the withdrawal of cash from the medical office. First of all, there is an advantage in having a bank account for the office practice and a personal account for personal matters. It is best to draw a set amount each week or each month from the office account and put it into the personal account rather than drawing out whatever is there or spending whatever happens to be needed. There is no question that the high income professional gets into just as much financial trouble by spending too much of his income as does the lower paid factory worker. The advantages of systematic withdrawals from the office cannot be overemphasized.

Most doctors will be paying their income tax on a quarterly estimated basis, and most of them will prepare this year's estimate based on last year's tax. The result of this is that a doctor will have to pay additional tax on the increase in his income from one year to the next, and provision for this extra tax is absolutely necessary. Professionals take care of this in a variety of ways. For example, a doctor can simply keep track of his income and ask his tax adviser to let him know where he stands during the year. Another method that works very well for some people is that of taking a percentage of all withdrawals made from their office and placing it into what they would call a tax account from which they make all of their tax payments. This is a good way to insure that money that will belong to the Government when the tax return is filed will not be spent. On this subject, the method of tax accounting a doctor chooses will greatly affect his working capital needs. If he elects the cash basis of accounting, then he doesn't have to report as income his fees until they are paid. Thus he will not have to pay income tax on income which is not in cash form. In my opinion there would practically never be an instance where the accrual basis of accounting would be preferable over the cash basis.

I mentioned earlier that accounts receivable are the major item included in the working capital. The type of billing system and the method of follow-up a medical office will have for accounts receivable is extremely important and if properly handled will result in the need for much less working capital. If a doctor has the right tax method of accounting and a good billing system for his accounts receivable, he will find in most instances that his demands for cash will diminish very shortly after he goes into practice, thus enabling him to spend more of his time on medical matters for which he is better trained.